S. HRG. 99-246, PT. V

TAX REFORM PROPOSALS—V

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

JUNE 18, 1985

(Debate on Corporate Tax Burden)

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE
51-233 O WASHINGTON : 1986

S361-17

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TAX REFORM PROPOSALS—V

TUESDAY, JUNE 18, 1985

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The committee met, pursuant to notice, at 9:36 a.m., in room SD-215, Dirksen Senate Office Building, the Honorable Bob Packwood (chairman) presiding.

Present: Senators Packwood, Danforth, Chafee, Heinz, Wallop, Symms, Grassley, Long, Bentsen, Matsunaga, Moynihan, Baucus, and Bradley.

Also present: William Diefenderfer, chief of staff.

[The press release announcing the hearing follows:]

[Press Release No. 85-033—May 30, 1985]

CHAIRMAN PACKWOOD ANNOUNCES FINANCE TAX REFORM HEARINGS

Senator Bob Packwood (R-Oregon), Chairman of the Committee on Finance, travelling in Oregon, today announced that the Committee will begin hearings in early June on President Reagan's tax reform proposal.

"The Committee's work on the President's proposal will begin with Treasury Secretary Baker's testimony on June 11th," said the chairman of the Senate tax-writing committee, "and will involve upwards of 30 days of hearings—3 or 4 days each week the Senate is in session during the months of June, July and September."

Chairman Packwood announced the first five days of hearings, as follows:

Secretary of the Treasury James A. Baker III will present the President's tax plan to the Committee on Tuesday, June 11, 1985.

Internal Revenue Service Commissioner Roscoe Egger will appear before the Committee to testify on Wednesday, June 12, 1985.

On Thursday, June 13, 1985, the Committee will receive testimony from invited national business leaders.

On Monday, June 17th, public witnesses will testify on the impact of the tax reform proposal on people below the poverty line.

On Tuesday, June 18, 1985, witnesses invited by the Committee will discuss the general issue of whether corporations ought to pay a higher percentage of the income tax burden.

All hearings will begin at 9:30 a.m. and will be held in Room SD-215 of the Dirksen Senate Office Building.

The CHAIRMAN. The committee will come to order, please. This morning we are going to have—I will call it a debate. Marty said he hoped it would not be a brawl, and I don't think it will, but we are going to use a slightly different format than we have had before. The proposition is: Should corporations bear a greater percentage of the tax burden? The reason I chose this today—and if it works out we may do it on some other occasions—frequently, we will have a series of witnesses in who speak on one side of an issue. And then a day later, or a week later, or a month later, we will have witnesses in to speak on the other side of the issue. And we are inclined to think, oh, I wish I had asked that question at the time when I had that person here. In fact, I have used this format before in my office, in having proponents and opponents come in and debate mainly scientific matters. I recall when we first voted on the ABM—the Antiballistic Missile System in 1969—initially Dr. Hahn's Beta came into my office and explained to me why it didn't work—scientifically, why it didn't work. And then a week or so later, Dr. Wolfgang K.G. Pinofsky came in and explained to me scientifically why it did work. And having barely touched mathematics and a little bit of chemistry in college, I was simply at sea scientifically. So, I subsequently had a debate between some good scientific experts, and I have done it with the MX. I have done it with other weapons systems, and I have found it most helpful. So, today, each of the witnesses will speak about 5 minutes—pro-con, pro-con—and then we will open it up for questions, but in this case, I would not normally follow exactly our format necessarily of 5 minutes of questions, and I would encourage the witnesses to interrupt us if they want or to interrupt each other when we get to that phase of the questions and answers. And we will speak in the order of Dr. Martin Feldstein first, then Dr. Joseph Minarik, then Dr. Norman Ture, and then Dr. Richard Goode. And then we will open it up for questions and answers and interruptions. So, Marty, if you are ready to start?

STATEMENT OF DR. MARTIN FELDSTEIN, PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY, CAMBRIDGE, MA

Dr. **Feldstein**. Thank you very much, Senator. I am certainly very pleased to be back with you and this distinguished committee.

I think the President's proposal is basically a very attractive one, but I think the administration has tried too hard to make it irresistible by giving individual taxpayers a $25 billion annual tax cut. And to finance that cut in personal taxes while maintaining total revenue approximately constant, the administration has had to propose a $25 billion annual increase in corporate tax collections, an increase as you know equal to about 29 percent in corporate taxes.

I am pleased that the committee is focusing today's hearing on the question of whether corporate taxes should now be raised to finance another major reduction in personal taxes. My answer is, simply, "no." In my testimony, I have discussed six basic points supporting that conclusion. Because the time is so limited, I will submit the full statement for the record, and I will simply read the six concluding comments in the testimony and hope that, in the general discussion and debate, we can get back to the substance of some of the arguments.

First, I would say that indexed depreciation, as proposed by the administration, is a very valuable reform. I think it should be enacted, but I think that the proposed rates of depreciation should be increased because, with the current schedule, the proposal would actually raise the cost of capital, and that in turn would lead to lower rates of investment. Similarly, I think that eliminating the investment tax credit as proposed would sharply increase the cost of investing in business equipment and that would result in a substantial reduction in equipment investment. I think the ITC should be retained, but if it is to be eliminated, I think the depreciation schedule should be adjusted to maintain the overall incentive to invest.

I also want to stress that the specific proposal of the administration to eliminate the investment tax credit in January 1986 would probably cause a recession in 1986. I think if the ITC is to be eliminated, the effective date should be postponed until 1987. I say that because I think 1986 is going to be a weak year. That weakness in the short term is going to be reinforced by whatever deficit cutting action the Congress passes this year, and on top of that, to have the contractionary effects of eliminating the ITC seems like a surefire recipe for creating a recession in 1986. By 1987, the effects of lower interest rates and a lower dollar—which I expect will have come before then—by 1987, will be giving the economy a substantial boost. Therefore, if there has to be a contractionary effect on investment, it would be far better to have it come in 1987.

Let me turn now to the so-called windfall tax on the difference between accelerated and straight-line depreciations. I think, to put it bluntly, it is an unfair and absolutely unprecedented retroactive change in depreciation rules for investments that have already been made. The tax would cause a temporary drop in investment spending. It would also cause upward pressure on interest rates as firms borrow to avoid even larger cuts in investment spending. I think that tax should not be imposed, and a different source of $55 billion of revenue over the next 4 years should be found.

I find the Treasury's argument for this one-time temporary tax simply unconvincing. They argue that those who deducted depreciation against 46 percent corporate tax rates since 1980 should not have been allowed to do so because the resulting profits will only be taxed at 33 percent. But of course, much of the future profits will result from investments that were made before 1980 or from activity that didn't involve investment in plant and equipment at all, like R&D activity or managerial improvements or advertising. So, I see no justification at all for retroactively reducing the value of depreciation taken during the past 4 or 5 years.

My fifth point is that an argument that we very frequently hear—that corporate taxes are now a much smaller share of total Federal taxes than they were two decades ago and that, therefore, they should be brought up to that historic level—just doesn't hold water. The text of my testimony on pages 7 and 8 shows that the decline in the corporate tax share, that has happened virtually every year since 1960, has not been due to more favorable tax rules, but has been caused by the rise in the share of total Federal taxes going to payroll taxes, an inevitable consequence of expanding Social Security, and also—and even more importantly—the increase in corporate interest payments that simply shift who pays the tax from the borrower—the corporation—to the creditors. That has really explained virtually all of the decline that has occurred in the corporate tax share of total Federal receipts.

My final point returns to the general question that you raised in setting the topic for today's testimony. I think the key thing to note is that reducing the personal tax rates to 15 percent, 25 percent, and 35 percent in a revenue-neutral tax reform does not require an increase in corporate taxes. I think there is simply no justification for a net reduction in individual income tax revenues at the present time. There are a variety of changes in the administration's proposal that would make it possible to reduce personal tax rates without increasing corporate taxes. One such change, which I elaborate on in the testimony, would be to target the increase in the personal exemption. A targeted increase in the personal exemption, focusing it on those with incomes below $30,000, in place of the indiscriminate increase that the administration has proposed, would save about $20 billion a year.

I think there really is a great opportunity now for an historic improvement in the tax system. I think the President's proposal provides a framework within which a fairer system with strengthened economic incentives can be developed, but I think in its current form, the proposed tax changes would weaken the incentive to invest in plant and equipment, would increase future budget deficits, and would hurt economic growth. Perhaps it was inevitable that a Republican administration, concerned that it would be accused of being too favorable to business, would bend over backwards by increasing taxes on business in order to finance tax cuts on individuals. That may have been safe politics, but I think it is bad economics. Business tax increases that reduce productivity-raising investment would eventually weaken our economy and hurt those lower income individuals who were temporarily helped by personal tax reductions. I hope that the Congress can take a bipartisan approach to tax reform that preserves the incentives for investment and for economic growth. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. Dr. Minarik.

[The prepared written statement of Dr. Feldstein follows:]

Should Corporate Taxes be Increased?

Martin Feldstein

Testimony before the Senate Finance Committee
June 18, 1985

Thank you, Mr. Chairman. I am very pleased to appear before this committee to discuss the President's proposal to reform our tax system.

The President's proposal is attractive in many ways. But I believe that the Administration has tried too hard to make its proposal irresistible by giving individual taxpayers a $25 billion annual tax reduction. To finance that reduction in personal taxes while maintaining total revenue approximately constant, the Administration has had to propose a $25 billion annual increase in corporate tax collections. Since personal taxes are now four and a half times as large as corporate tax collections, this shift in the tax burden involves a six percent cut in personal taxes but a 29 percent rise in corporate taxes.

I am pleased that this committee is focusing today's hearings on the question of whether corporate taxes should now be raised in order to finance a reduction in personal taxes. In answering the question, I will not discuss the special rules for particular industries like banking or oil drilling but will concentrate on three things: the proposed permanent changes in depreciation rules; the elimination of the investment tax credit; and the temporary imposition of a so-called windfall profits tax based on past depreciation deductions.

1. Indexed depreciation is a valuable reform but the proposed rates of depreciation should be increased to avoid a rise in the cost of capital.

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* Professor of Economics, Harvard University, Testimony before the Senate Finance Committee, June 18, 1985.

The key to understanding the Administration's proposed changes in depreciation is the idea of indexing depreciation allowances to the price level. I think that the extension of inflation indexing to the measurement of depreciation is an extremely valuable change in tax rules. Only indexed depreciation can provide an honest and accurate measure of the cost of replacing plant and equipment. Indexed depreciation is therefore a fairer method of taxation than current rules. It also eliminates the risk that unanticipated future inflation could again dramatically reduce the value of depreciation allowances and raise effective tax rates on business investments as it did in the 1970s.

The shift to indexed depreciation makes it difficult to compare current business taxation with the Administration's proposed rules. Although investments would be depreciated over a longer number of years and at a slower rate than under current ACRS rules, this would be largely offset by the annual adjustments for inflation. For example, equipment which is now depreciated over 5 years with an initial 40 percent depreciation rate would generally be subject to a 7 year recovery period with an initial 22 percent depreciation rate. Although this would clearly reduce the present value of the depreciation allowances if there were no inflation adjustment, the indexing of depreciation would just about offset the slower rate of depreciation if the inflation rate is five percent. At a higher rate of inflation, the indexed depreciation would be more valuable than current ACRS rules.

The relative value of indexed depreciation is not as great as the Treasury's calculations suggest because the Treasury assumes that the real cost of funds to firms is only 4 percent when their actual cost of funds is generally a good deal higher. This means that the effective tax rates on business investments are actually greater than the Treasury calculations imply. This is particularly important for structures since they are depreciated over a long period of time.

The Administration proposes to replace the present 18 year accelerated depreciation schedule for structures with a 28 year schedule that starts with a 4 percent depreciation rate. Despite the longer recovery period and slower depreciation rate, the indexed depreciation can be as valuable as the current rule becuase with a five percent inflation rate the investor is able to take $2,128 of depreciation allowances over the life of the investment for each $1000 of initial investment. If the firm's real cost of funds were only 4 percent, as assumed by the Treasury in its calculations, the present value of the indexed depreciation allowances would actually be slightly greater than the present value of the current ACRS depreciation allowances. But with a more realistic 7 percent real cost of funds, the present value of the indexed depreciation schedule would be less generous than ACRS. The proposal to tax capital gains on structures at ordinary income tax rates further increases the cost of capital for investment in structures.

A reduced value of depreciation allowances increases the cost of investment and therefore reduces the incentive to invest. Although I very much favor the adoption of the indexed depreciation method, I believe that the proposed specific depreciation schedules should be increased to maintain the current value of depreciation allowances and therefore the current incentive to invest.

2. Eliminating the investment tax credit would sharply increases the cost of investing in business equipment and would result in a substantial reduction in equipment investment. I believe that the ITC should be retained. If it is to be eliminated, depreciation schedules should be adjusted to maintain the incentive to invest.

Experience shows that the investment tax credit has been a powerful stimulus to invest. If it is eliminated, capital that now goes into equipment will be diverted into office buildings, shopping centers, housing, and other types of investment that do not have the same effects on employee productivity. Some capital would also be diverted abroad in pursuit of higher after-tax returns. American industry would not be able to afford the productivity-increasing equipment needed to remain competitive in many high technology world markets.

Although the $25 billion a year increase in business taxes would permit a reduction in corporate tax rates, the net effect would undoubtedly be to reduce investment. Indeed, it is difficult to understand the rationale for raising the tax rate on new investment in order to lower taxes on the profits that result from past investments, from brand loyalty, or from other sources that are not responsive to current tax rates.

I believe that the investment tax credit should be retained in some form even if that limits the reduction in the corporate tax rate. Alternatively, the ITC could be eliminated and the depreciation schedules for productivity-raising equipment modified in a way that maintains the current cost of equipment investment.

3. Eliminating the ITC on January 1986 would probably cause a recession in 1986. If the ITC is to be eliminated, the effective date should be postponed until 1987.

The economy is clearly slowing down from the very fast pace of expansion in 1983 and 1984. The deficit reduction legislation that is so important for the long-term health of the economy will probably further reduce the pace of the economic activity in 1986. Although the lower interest rate and more competitive dollar that result from deficit reduction will eventually be a major stimulus to economic activity, the immediate effect of cutting government spending will be to reduce demand and output.

Eliminating the investment tax credit would substantially reduce the incentive to invest in business equipment. Companies are likely to accelerate their investment spending to get as much done in 1985 as possible to take advantage of the ITC before it is eliminated. As a result, investment in 1986 would fall off sharply, causing a further decline in overall demand that could push the economy into recession.

To avoid causing a 1986 recession and to reduce the risk of a recession at any time in the next few years, the effective date for eliminating the ITC -- if it is to be eliminated -- should be shifted to January 1987. Doing so would give businesses the incentive to invest more heavily in 1986 before the ITC is lost and would thus stimulate demand during the year when it is needed to offset the short-term effect of deficit reduction. By 1987, the favorable effects of deficit reduction legislation on interest rates and the dollar should be producing enough of an increase in net exports and in interest-sensitive spending to permit the ITC to be eliminated without causing a recession.

The adverse revenue effect of postponing the elimination of the ITC could be balanced by reducing the corporate tax rate in two steps, with a partial cut in 1986 and the full cut in 1987.

I might just add that businesses are now making capital investment decisions for 1986. Prudence requires them to assume that the ITC will not be available next year. If the Committee is likely to postpone the effective date for eliminating the ITC (or not eliminate it at all), it is important for the chairman to say that publicly before it is too late to preserve a healthy level of investment in 1986.

4. The so-called windfall tax (on the difference between accelerated depreciation and straight line depreciation) is an unfair and absolutely unprecedented retroactive change in depreciation rules for investments that have already been made. The tax would cause a temporary drop in investment spending and upward pressure on interest rates as firms borrow to avoid even larger cuts in investment spending. This tax should not be imposed and a different source of $55 billion of revenue over the next 4 years should be found.

The Treasury argues that those who deducted depreciation against 46 percent corporate tax rates since 1980 should not have been allowed to do so because the resulting profits will only be taxed at 33 percent. But much of the future profit will result from investments made before 1980 and from activities that do not involve any investment in plant and equipment at all (R and D, managerial improvements, advertising, etc.). There is simply no justification for retroactively reducing the value of depreciation taken during the past five years.

Such a retroactive change in depreciation rules would make businesses justifiably suspicious about the value of future depreciation benefits. And if businesses cannot rely on the government to give the full value of promised depreciation, the incentive to invest will be substantially reduced.

Since this extra tax was not part of the Treasury's original proposal, it certainly looks like it was invented to plug a large temporary revenue shortfall and not because of any good tax policy reason. The revenue shortfall could be avoided by phasing in the reduction of personal rates or the increase in the personal exemption. For example, raising the personal exemption to $1,500 immediately and then to $2,000 in 1990 -- instead of going to $2,000 immediately as the Administration proposes -- would completely eliminate the need for this capricious and counterproductive tax increase.

5. The decline since 1960 in corporate taxes as a share of total federal tax receipts does not provide a justification for increasing corporate taxes now.

Corporate income taxes were 23 percent of total federal taxes in 1960, 17 percent in 1970 and only 9 percent in 1984. But this often-cited comparison gives the totally misleading impression that the fall in the corporate tax share of total federal revenue has been due to a continually more favorable tax treatment of business income. In reality, the business tax share has declined because of other changes that have been taking place in the economy.

One important reason for the decline in the corporate tax share of total revenue has been the rapid growth of Social Security programs and, therefore, of the earmarked taxes that are used to pay for them. Between 1960 and 1984, the taxes needed to pay for those programs rose from 3 percnt of GNP to nearly 7 percent of GNP. That increase raised social insurance taxes from 16 percent of total federal revenue in 1960 to 36 percent in 1984 and brought with it a corresponding reduction in the tax share provided by corporate taxes.

The major explanantion of the decline of corporate taxes has been a shifting of some of the tax on business income from the corporations themselves to the individuals who provide the capital for those corporations. That has occurred because corporate interest payments have been rising continuously over the past quarter century. Those interest payments are tax-deductible expenses of the corporations that pay them and are part of the taxable income of the individuals who receive that interest either directly or through financial intermediaries such as banks.

To get a meaningful picture of what's been happening to the tax burden or corporate capital, we have to adjust the raw figures for this shifting of the tax from the corporations to the individuals who provide the capital.

A study published a few years ago showed that the federal taxes paid by nonfinancial corporations, their creditors and their shareholders were 62 percent of the real capital income of those corporations in 1960, declined to 48 percent in 1965 and then rose to 66 percent in 1979. Unfortunately, more recent evidence is not available. But these figures show how the effective total tax on corporate capital income actually rose during two decades while the corporate taxes as a share of total federal revenue was falling sharply.

We can look also at how the rise in interest costs has been a major cause of the decline in taxes paid directly by corporations. The average interest rate that corporations paid on their bonds tripled between 1960 and 1984 and the net interest expenses of nonfinancial corporations rose from 9 percent of their pretax profits in 1960 to 44 percent in 1984. If interest payments had been as large a share of profits in 1960 as they became by 1984, the corporations' 1960 tax liabilities would have been cut by 36 percent.

As a rough approximation, adjusting for the rise in interest expenses in this way would reduce the 1960 corporate taxes to 15 percent of total federal tax revenues and 17.5 percent of the total federal revenues other than the earmarked Social Security taxes. By contrast, 1984 taxes were 13.3 percent of federal revenue other than Social Security taxes. The Congressional Budget Office estimates that share will rise to nearly 16 percent by the end of the decade under existing tax laws.

In short, adjusting for the increased importance of Social Security and the rise in corporate interest outlays explains virtually all of the decline in the corporate tax share of federal revenues.

6. Reducing the personal tax rates to 15 percent, 25 percent, and 35 percent in a revenue neutral tax reform does not require an increase in corporate taxes. There is no justification for a net reduction in individual income tax revenues at the present time. A targetted increase in the personal exemption in place of the indiscriminate increase proposed by the Administration would save $20 billion a year.

After the massive personal tax cut of 1981 and in the face of frightening budget deficits that we still face for the years ahead, it would be irresponsible to reduce individual income tax revenues in the current tax reform. If corporate tax revenues are increased by eliminating currently inappropriate corporate tax rules, the extra revenue should be devoted to deficit reduction.

The current Administration proposal is at best revenue neutral and has a substantial risk of losing substantial revenue. It would be a fiscal disaster if tax reform became a deficit-enlarging tax cut.

An increase in tax revenue is definitely needed to reach the desirable goal of cutting the deficit to 2 percent of GNP by 1988 and reaching a balanced budget by early in the next decade. Some of the proposed revenue-losing changes should be scaled back or refocussed so that the final bill helps to reduce the future defícts.

The proposed increase in the personal exemption from $1,080 to $2,000 would cause a huge $40 billion annual revenue loss, would disproportionately benefit higher income groups, and would discourage work effort. Tax relief to low income taxpayers and to families with children could be targetted in a way that saves billions of dollars and improves the incentives to work and to save.

The President's current proposal to raise the personal exemption for everyone would actually give a bigger tax break to a couple with no children in the top 35 percent bracket than to a family with two children in the lowest 15 percent bracket. This uneven tax cut happens because the value of the additional exemption increases with the taxpayers marginal tax rate. About 38 percent of the $40 billion annual tax cut due to increased personal exemption would go to the top 17 percent of taxpayers, those with incomes over $40,000.

The increased exemption for higher income taxpayers does not have any of the positive incentive effects that result from reductions in marginal tax rates. Indeed, the rise in the personal exemption is a disincentive since the increase in the taxpayer's total after-tax income -- with no change in the after-tax reward for additional earnings -- reduces the incentive to work. This kind of intramarginal tax cut for upper income individuals is the opposite of good supply-side policy.

The right way to help low income taxpayers without the enormous revenue loss of the current proposal is to target tax relief. Perhaps the simplest such modification of the President's proposal would be to increase the personal exemption to $2,000 only for families in the 15 percent bracket -- that is for couples and families with taxable incomes up to $29,000. Those in the 25 percent bracket -- with incomes between $29,000 and $70,000 -- could be given a more modest increase to $1,200. For both groups of taxpayers, these exemptions would reduce taxes by $300 per person. Those with incomes over $70,000 would continue to receive the $1,080 exemption provided under current law.

Targeting the increased exemption in this way would cut the revenue cost in half -- to $20 billion a year instead of the $40 billion implied by the President's proposal. The targeted exemption would nevertheless provide as much relief to low income families and individuals and would take as many people off the tax rolls as the President's plan.

There are, of course, other possible ways to target the increased exemption. I believe that reshaping the proposed increase in the personal exemption should be a top priority of this Committee if it wants to avoid the adverse consequences of an enlarged deficit and of counterproductive increases in business taxation.

Concluding Comments

There is a great opportunity now for an historic improvement in the American tax system. The President's proposal provides a framework within which a fairer system with strengthened economic incentives can be developed. But in its current form, the proposed tax changes would weaken the incentive to invest in plant and equipment, would increase future budget deficits and would hurt economic growth. It's now up to the Congress to build on the President's proposal.

It was probably inevitable that a Republican administration, concerned that it would be accused of being too favorable to business, would bend over backwards by increasing taxes on business in order to finance tax cuts on middle and lower income individuals. That may be safe politics but it is bad economics. Business tax increases that reduce productivity-raising investment would eventually weaken our economy and hurt the lower income individuals who are temporarily helped by personal tax reductions. I hope that Congress can take a bipartisan approach to tax reform that preserves the incentives for investment and economic growth.

STATEMENT OF DR. JOSEPH J. MINARIK, SENIOR RESEARCH ASSOCIATE, THE URBAN INSTITUTE, WASHINGTON, DC

Dr. MINARIK. Thank you, Mr. Chairman. I would like to refer to an outline that was made available to the committee last week. I also have a longer statement that I would like to have entered in the record.

The CHAIRMAN. All of the statements will be entered in the record.

Dr. MINARIK. Thank you, Mr. Chairman. It seems to me in looking at this question of whether we should increase corporate taxes that one of the first questions that we have to ask is really whether we will increase corporate taxes. I think that that is, in part, a prior question because of what President Reagan has done in proposing that corporate tax increase, and I think the President has reduced our flexibility in this area. The President has proposed a tax reform that is a net tax cut for the individual sector, and he has held that tax cut out in front of the taxpayers. I think it is going to be very difficult now because of the way the President proceeded to take that tax cut back, and I will elaborate on that a little bit more a bit later in my statement.

I would also point out that there are some real questions about the magnitude of the actual corporate tax increase in the administration's package. As I note in the outline, the administration's relatively back-loaded depreciation system in effect postpones a large amount of tax deductions. Those deductions are indexed, and as a result, the administration comes to a longrun estimate of increases in corporate taxes of about 9 percent, as opposed to the 29 percent that we see in the very short run. So, the size of the tax increase in the administration's package over the long haul is really not that large, and as a matter of fact, it may be a source of trouble in terms of keeping the budget deficit in range over the long run.

Let me talk a little bit about the question of whether or not we can afford to increase corporate taxes. As Professor Feldstein mentioned in his presentation, there has been a trend toward decreasing corporate tax revenues, both as a share of the total Federal tax take and as a share of the gross national product over the post World War II period. Now, Professor Feldstein suggests that that is a confusing series of data, and that we should not draw from it the conclusion that we can go back 20 years in terms of raising the corporate tax burden. I want to suggest that that is a bit of an exaggeration because the administration really isn't proposing anything like going back 20 years in terms of the tax burden. I would refer you to tables 1 and 2 at the end of my prepared statement which show that what the administration is doing in terms of an increased corporate tax burden by either the measure of revenues as a share of total tax revenues or as a share of GNP is really only moving us back to 1980—not nearly to the range of the 1960's and the 1970's. Another point is that, while Professor Feldstein is absolutely correct that a large part of the deterioration in corporate tax liabilities historically has been due to an increasing tendency toward debt finance and higher interest rates and therefore larger corporate interest deductions and a smaller corporate tax base, that in large part that trend has been turned around. And it is not necessarily correct to say that the trend of a shrinking corporate tax based on that ground is going to continue and, for that reason, that we have to be hesitant about increasing corporate taxes.

Let me suggest as well that, if we look at the administration's figures in terms of where the tax increase on the corporate sector comes, you will find that a substantial share of the tax increase—and by 1990, almost all of it—comes not from changes in the general provisions of the corporate tax code. Rather, it comes from provisions that are targeted toward sectoral areas of abuse and subsidies that many of us would believe are not really justifiable over the long haul. If you take into account the general provisions in the administration's package, in which I would include the rate cuts, the repeal of the investment credit, the revisions to the depreciation system, the recapture provision for windfall, and the dividend deduction, you would find that by 1990 the net tax increase from those provisions comes to about $2 billion. So, this is a far cry from the total tax increase of about $25 billion. The difference—the additional $23 billion—comes from these sectoral provisions which, I think, many of us would agree have some serious problems.

Now, inasmuch as my time is up, I imagine I should stop, Mr. Chairman, but let me suggest just very briefly that we ought to take into account when we consider the effects of such a tax increase other provisions in this particular tax package which lean in the opposite direction. As my colleague, Charles Hulten, has pointed out, and the administration's figures bear him out, the overall taxation of capital in the administration plan, taking into account the rate reductions and the other provisions, is in fact somewhat more liberal than we have under the current law. There is something of a twist in the relative taxation of equipment as opposed to structures, and inventories and other forms of corporate capital, but taking all corporate capital into account, the tax burden on capital, in fact, declines. It is important to keep in mind that if we want to have a tax system that provides targeted incentives to one particular kind of capital and taxes other kinds of capital more heavily, we really have a burden of proof to demonstrate that this kind of an industrial policy—and that is really what it is—is in fact beneficial for the economy. There is, it seems to me, and there should be among economists a tendency to trust the market system as opposed to having differential taxation of different kinds of capital assets affect the way the economy works. And it seems to me that is a very important point here. In deference to the timekeeper, let me stop, Mr. Chairman. Thank you very much.

The CHAIRMAN. Thank you. Dr. Ture.

[The prepared written statement of Dr. Minarik follows:]

Should We Increase Corporate Taxes?

Testimony of

Joseph J. Minarik
Senior Research Associate
The Urban Institute

Before the

Committee on Finance
United States Senate

June 18, 1985

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SHOULD WE INCREASE CORPORATE TAXES?

Unlike earlier tax reform proposals, the president's plan would increase tax collections under the corporate income tax. This aspect of the plan has been hailed by some as an important stride toward distributive justice, and condemned by others as a step backward in our drive toward greater capital formation and economic growth. Evaluating such a policy change requires a perspective of both the present and the past, of both economics and politics.

I. WILL WE INCREASE CORPORATE TAXES?

Though it might seem incongruous, the first question we have to ask about increasing corporate taxes is not whether we should, but whether we will. At least in my opinion, the president's approach to tax reform has very much limited our options on this particular issue.

Prior to the release of the first version of the administration's proposal, tax reform was billed as a revenue-neutral reshuffling of individual and corporate tax liabilities, with the gains of the winners equal to the losses of the losers within each sector. The president offered a different configuration, with a net tax cut for the household sector precisely financed by a net corporate tax increase. This approach apparently was motivated in part by the political reality that people vote while corporations do not, and in part by structural considerations. The president has attempted to capitalize upon this feature by billing his proposal as tax relief and freedom from unjust burdens for individuals, with newly imposed taxes on heretofore tax-free profitable corporations. The president further argues that the elimination of tax loopholes will require any future tax increase to be more obvious and widely felt, and that tax reform will therefore put downward pressure on the future size of the federal government.

This tax-cut cat, now let out of the bag, will be hard to catch and put back in. If people have heard the president's message and come to believe that tax reform is a tax cut, it will be difficult to sell a tax reform that does not cut taxes in the household sector. Even though a revenue neutral tax reform can have more winners than losers, there is no question that a tax reform that is a household-sector tax cut can deliver more and bigger winners. And if the public motivation for tax reform is more a tax cut and less the principles of simplicity and equal taxes on equal incomes, a more conventional tax reform will surely meet with a stony reception.

As alluded to above, there are structural factors at work as well. The Treasury was rumored to have found the corporate tax base so riddled with loopholes that once those loopholes were eliminated in the original plan, the corporate tax simply raised far more revenue than the current law even at much lower rates. If the corporate rate had been made equal to the highest individual rate in Treasury I, the corporate tax would have been increased even more. Setting the corporate rate sufficiently below the top individual rate to achieve corporate revenue neutrality would have set off a rash of personal incorporation to take advantage of the lower corporate rate. While the corporate tax base in the president's plan is significantly narrower than in the Treasury's draft, a built-in corporate tax increase is still evident (though somewhat smaller), and still makes a corporate tax increase hard to avoid.

Under both Treasury I and the president's plan, there were some doubts about the staying power of this corporate tax increase. Both plans shifted business depreciation deductions to a more "back-loaded" basis, with the allowances postponed and indexed for inflation. At some future date, the postponed and indexed allowances for early investment would come due in greater amounts than the reduction of initial allowances for then-current investments. The result would be the beginning of an erosion of the short-run corporate tax increase. The administration itself states as much when it values its long-run corporate tax increase at 9 percent, in contrast to the short-run increase of about 22 percent. This erosion might cast doubt on the inevitability of a corporate tax increase, but presumably the long-run revenue shortfall would have to be made up in some way. The same political logic that suggested the short-run corporate tax increase would most likely carry the day, and the additional revenues would most likely come from the corporate side.

The bottom line is that the president has, at the very least, changed the way in which we look at the prospect of a corporate tax increase; at most, he may have made higher corporate taxes an inescapable part of tax reform.

II. COULD WE INCREASE CORPORATE TAXES?

We might wonder whether corporate tax increases of the magnitude contemplated by the administration would be historically out of bounds. Putting new and unprecedented burdens on the corporate sector could be seen as an unnecessary risk that we should avoid at any cost.

The historical record suggests, however, that the corporation income tax increases contemplated by the administration would remain well within previously explored territory. Table 1 shows that corporate tax revenues have declined dramatically as a percentage of total federal revenues over the post-World War II years. From more than 30 percent of total revenues at times in the late 1940s and early 1950s, the corporate share fell below 25 percent in 1959, below 20 percent in 1968, below 15 percent in 1979, and below 10 percent in 1982. The ratio of corporate to individual income taxes fell from three-fourths in 1946 to less than one-half by 1968, to one-third by 1978, to one-fourth by 1981, to about one-fifth today. By both of these measures, the president's proposal will take us back no further than the 1970s. It may be worth remembering, therefore, that corporate taxes were relatively much larger at times in our history when our economic performance was quite satisfactory.

Another measure of the corporate tax burden over time is the ratio of corporate taxes to GNP. Table 2 shows that this pattern is quite similar to that of corporate taxes relative to total revenues. Corporate receipts were as much as 6 percent of GNP in the early post-War years, but fell below 5 percent by 1957, below 4 percent by 1970, below 3 percent by 1971, and below 2 percent by 1982. Again, the president's proposed corporate tax increase would do no more than take us back into the range of the 1970s.

Some analysts have argued that the corporate tax decline of the past 30 years was not so much the result of policy as of arithmetic. The argument is the corporate profits fell substantially, and the corporate taxes very naturally followed. There is something to this argument. Over the 1960s and 1970s, corporate profits did decline significantly as a share of GNP. However, this trend was very closely linked to the economic conditions of the period; in particular, rapid inflation and high interest rates raised the interest costs of corporations and encouraged greater use of debt finance. After deduction of net interest expense, corporate profits declined as a percentage of GNP.

It would not be correct to conclude from the decline of the profit share of the 1960s and 1970s that a corporate tax increase in the 1980s would put a larger burden on a smaller base. The conditions that caused the 1960s and 1970s profit slowdown, primarily high and rising inflation and interest rates, no longer obtain. Table 3 shows that interest obligations in the nonfinancial corporate sector have begun to recede as a percentage of GNP, and so profits are recovering as a share of income. The administration's economic forecast, on which its tax revenue estimates are based, anticipates a continued decline in interest rates and would continue this trend. If this forecast should fail to materialize, the effects would visit themselves upon whatever tax law we have in place.

Further, an important benefit of tax reform is a reduction in the tax system's inducement toward debt finance. Lower statutory tax rates reduce the tax share of interest that is in effect paid by the federal government through the tax deductibility of interest. Thus, swollen corporate interest expenses and depleted taxable income bases would be less likely in the future. This means that the administration's forecast of increased corporate tax revenues is not a squeezing of further revenues from a depleted corporate income base, nor is it likely to become so in the foreseeable future.

The administration has targeted another conceptual source of revenue in its windfall tax on the benefits of recent depreciation allowances. The administration makes the correct point that recent investments would receive a "double dip" benefit in the transition from a tax system with large, front-loaded tax subsidies to a system with lower statutory tax rates. Recent investors have claimed accelerated depreciation deductions against high tax rates; they would then pay tax on their postponed recognition of income at new, lower tax rates. This windfall benefit led the president to propose a tax on part of recent depreciation deductions. Many observers have quarreled with the fairness of the precise formulation of this windfall tax and the failure to address other windfall benefits (and losses), and some have argued for a phase-in of the corporate rate reduction as an alternative. Nonetheless, the existence of the windfall and its potential as a source of additional revenue from corporations cannot be ignored.

In sum, a corporate tax increase would leave our revenue system well within its historical bounds, and would not be disproportionate to the size of the corporate income base, especially considering the recent and anticipated future course of the economy and the transition to a new law.

III. SHOULD WE INCREASE CORPORATE TAXES?

Even though a corporate tax increase of the magnitude contemplated by the administration would not be an unprecedented burden, some economists allege that it would unduly decrease national saving, capital formation, growth, and productivity. Through this chain of effects, it is argued, our general well-being would suffer.

We must realize, first of all, that the ill-effects of any necessary tax are relative; absent that tax, burdens and distortions would have to be imposed somewhere else in the economy to acquire the needed revenue. The issue, then, is whether any given tax is more painful than its alternative. Further, every tax or tax increase must be considered in the context of the entire revenue system; any particular alternative may or may not harmonize acceptably with the rest of the system.

Thus, it seems to me that the administration's package (or any other tax reform proposal) must be seen in a broad perspective in two respects. First, we must consider the package as a whole, rather than any single or small group of provisions. And second, we must consider the package within the context of the revenue system as a whole. Viewed in this broad sense, the administration's proposal seems to me to be far less disruptive of capital formation, investment, and growth than is often alleged.

In the first respect, the tax increase on corporations must be seen not only in terms of what it costs, literally and figuratively, within the corporate sector; it must also be seen for what it buys in the reform package as a whole.

The Revenue Burden

The burden of the corporate tax increase in the administration's proposal is easy to exaggerate, apart from the distinction between the relatively large short-term revenue gain and the much smaller pickup in the long run. One of the most important distinctions among the individual provisions of the administration's corporate tax package is between those that affect all corporations, on the one hand, and those that affect particular industry groups, on the other. The industry provisions generally repeal targeted subsidies or accounting abuses that have little or no justification and cause unfairness and economic distortions. In fact, when the revenue effects of the different provisions are aggregated into these two groups, the general provisions affecting all corporations come to very nearly a revenue wash; the net revenue gain, then, arises mostly from the questionable industry subsidies and abuses. This pattern is even clearer after the windfall recapture tax expires. Thus, the net additional burden on corporate activity in general is small or nil.

Corporate Investment Choices

Of course, even this increase must be viewed relative to a specific alternative. The most discussed alternative to the administration's proposal on the corporate side is not restoration of the industry subsidies, but rather a somewhat general investment incentive like the current law's investment credit. There is reason to believe that expansion of investment subsidies (beyond the newly introduced subsidy element in the administration's capital cost recovery system, or CCRS) would add little to growth and productivity over the long run.

If taken to the extreme of the current law, such subsidies yield effective tax rates on income generated by investments in equipment below zero. (Note that CCRS is more generous than the current law's depreciation system, ACRS, taken without consideration of the investment credit and at realistic rates of inflation. If the current law's investment credit were enacted in company with CCRS, effective tax rates on equipment would certainly be negative.) Such negative effective tax rates mean that over the lifetime of an asset and appropriately discounting for the time value of money, depreciation deductions plus the deduction equivalent of tax credits exceeds the income generated by the asset. The excess deductions and credits can shelter from tax income from other sources--hence the term "tax shelter."

Consider what these net subsidies, or negative taxes, are supposed to accomplish. The intent is to induce firms to undertake investments that they would not make if they were taxed at normal rates. In other words, the point is to cause firms to make investments that flunked the normal market test. This reality casts serious doubt on the assertion that the absence of net investment subsidies will result in the loss of dramatic technological and productivity improvements.

Of course, when the effective tax rate is negative, the market test has little meaning; investments need not yield any pretax profit to pass. It is such subsidies that are used under the current law to create tax shelters in volume far greater than prior to the institution of ACRS; the president's proposal, while far less ambitious than Treasury I, would reduce tax sheltering significantly. The price of tax shelters is wasted capital and lost public trust in the tax system and government; it is a subjective question which cost is worse.

The current law investment tax credit in all likelihood cannot induce additional total investment. For one thing, the credit is paid for all investments, even those that would have been made in the absence of a subsidy. To this extent, the credit is inefficient. Further, any investment actually induced by the credit must be made with funds bid away from other uses, thus presumably raising interest rates. If the investment credit is not truly general, then, it must change the overall composition of investment that the market would yield--increasing subsidized types of investment and decreasing others. (The current law, for example, subsidizes equipment at the expense of structures and inventories.) Thus, a targeted investment tax credit is a kind of industrial policy, presuming that the legislation is a better guide to the allocation of capital than the market process. This seems unlikely.

Financing Investment

Thus, the benefit of investment subsidies in lieu of the administration's proposed tax increase can easily be exaggerated. There is another perspective from which investment losses due to the proposed tax increase may be overstated, and that is the role of taxation in the household sector on the flow of funds into the the corporate sector.

Presumably, individuals purchase stocks and other financial assets on the basis of the expected after-tax return. Reductions of the tax wedge, as through reductions in marginal tax rates, presumably make such investments more attractive. In this respect, it is the total income tax burden on corporate investment that is relevant, and with the reductions of marginal individual income tax rates, there may be more funds from the household sector to cushion the additional tax burden on corporations.

Another issue is the reaction of nontaxable investors, such as pension funds and endowments of tax-exempt institutions. Such investors generally allocate their portfolios between two types of assets, corporate equity and debt instruments. Tax reform should have the effect of reducing interest rates (through a relationship known as Modified Fisher's Law), because lower tax rates reduce the tax benefit to borrowing (leading borrowers to demand lower interest rates), and increase the after-tax reward to lending (allowing lenders to accept lower interest rates). To the extent that this relationship leads to lower market interest rates, debt instruments become relatively less attractive to tax-exempt investors, meaning that corporate equity becomes relatively more attractive. This would steer more funds from tax exempts into the corporate sector.

I have no idea what the quantitative effects of these influences of tax reform on households and tax-exempt institutions would be--and I don't believe that anyone else does, either. But it seems to me that they must reduce the impact of a corporate tax increase on investment.

Statutory Tax Rates

Yet another ameliorative step in the administration's proposal is the reduction of the statutory corporate tax rate.

Cutting the maximum corporate rate from 46 to 33 percent (as well as reducing individual income tax rates in similar proportions) would reduce many tax-induced distortions, including the tax inducements to debt finance and retention of earnings. Further, the reduction in the statutory corporate tax rate may well alter corporate behavior, inducing firms to undertake risky investments that they believe could yield large returns. It could alter individual behavior as well. If an individual believes that a new corporate venture could earn large profits, he or she should realize that a lower statutory corporate tax rate would leave greater after-tax profit to distribute to shareholders or to reinvest. Thus, for successful firms, a lower statutory corporate rate should encourage investment.

In sum, a corporate tax increase in the context of tax reform could lead to a reduced amount of investment, but the tax reform itself would tend to make up part of this loss. Further, the quality of investment would be distinctly improved--that is, it would yield greater output and productivity--if the tax reform achieved neutrality in the allocation of investment. Thus, it is far from certain that the economy would be left worse off by such a policy choice.

Political Considerations

Apart from the issue of investment in the corporate sector, there are other considerations in the evaluation of a corporate tax increase. One is what additional corporate tax revenues imply for the individual income tax. A corporate tax increase can buy a reform of the individual income tax that is more politically attractive and acceptable than it would otherwise be. The household sector tax cut made possible by the corporate tax increase could grease the skids for achieving an individual income tax that is simpler and generally perceived as fair. It is possible, though not certain, that in the absence of a corporate tax increase, tax reform would not fly; thus, the realistic alternatives may be a corporate tax increase or the status quo. While it may not be universally agreed, there are those who would argue that on grounds of public respect for and compliance with the tax law, the status quo is not a viable option.

It may seem like the long way around, but a tax reform like that proposed by the president might be a necessary first stage to a later tax increase. One might argue persuasively that the current tax law is an exceedingly shakey base from which to launch a tax increase to reduce the deficit, from both a political and an economic perspective. A tax reform might create a vehicle that could stand such stress at some future date, should outlay reductions fail to meet our needs.

Within the household sector, one use of additional corporate revenues would be tax relief for low-income persons. This step is long overdue. The tax burdens of the poor and the near-poor have been increasing for a decade with little relief. Personal exemptions have remained virtually fixed since 1975 (taking into account the exemption credit that was in effect in that year and has since been repealed), and zero bracket amounts (then called minimum standard deductions) have increased only modestly, while the cost of living has doubled. The 23 percent tax rate cuts of 1981-84 were quite generous for many upper-income taxpayers, but were inadequate for low-income people who had been inflated onto the tax roles and therefore needed 100 percent tax cuts to make them whole. If taxes are to be cut for the poor and near-poor, the money has to come from somewhere. The corporate sector was the president's choice, and presumably will remain so unless someone comes up with a better idea.

A substantial tax increase on the middle class, incidentally, is not a better idea. Taxpayers in the $30,000 to $75,000 income range receive quite modest tax cuts on average, and many in this group take the plan's biggest hits from elimination of the deductibility of state and local taxes. Shifting the corporate tax increase to middle-income households would exacerbate this problem, and could arouse strong opposition and capsize tax reform.

IV. CONCLUSION

In sum, a corporate tax increase may be inevitable, given the president's espousal of tax reform as an individual tax cut. For other reasons, the corporate tax increase may be essential to attain tax reform on any terms.

A corporate tax increase would drain funds from the corporate sector, but other aspects of tax reform would moderate that flow. Further, a tax reform as contemplated by the president would tend to improve the allocation of investment and increase its impact on incomes and productivity. Alleged harmful effects on the economy are probably exaggerated. If the alternative to such a tax reform package is the status quo, then the net effect of the tax reform would certainly be positive.

Table 1

FEDERAL INCOME TAX REVENUES AS PERCENT OF ALL REVENUES, 1946-1990

	Type of Tax			
	Current Law		Administration Plan	
Year	Individual	Corporate	Individual	Corporate
1946	41.0	30.2	N.A.	N.A.
1947	46.6	22.4	N.A.	N.A.
1948	46.5	23.3	N.A.	N.A.
1949	39.5	28.4	N.A.	N.A.
1950	39.9	26.5	N.A.	N.A.
1951	41.9	27.3	N.A.	N.A.
1952	42.2	32.1	N.A.	N.A.
1953	42.8	30.5	N.A.	N.A.
1954	42.4	30.3	N.A.	N.A.
1955	43.9	27.3	N.A.	N.A.
1956	43.2	28.0	N.A.	N.A.
1957	44.5	26.5	N.A.	N.A.
1958	43.6	25.2	N.A.	N.A.
1959	46.3	21.8	N.A.	N.A.
1960	44.0	23.2	N.A.	N.A.
1961	43.8	22.2	N.A.	N.A.
1962	45.7	20.6	N.A.	N.A.
1963	44.7	20.3	N.A.	N.A.
1964	43.2	20.9	N.A.	N.A.
1965	41.8	21.8	N.A.	N.A.
1966	42.4	23.3	N.A.	N.A.
1967	41.3	22.8	N.A.	N.A.
1968	44.9	18.7	N.A.	N.A.
1969	46.7	19.6	N.A.	N.A.
1970	46.9	17.0	N.A.	N.A.
1971	46.1	14.3	N.A.	N.A.
1972	45.7	15.5	N.A.	N.A.
1973	44.7	15.7	N.A.	N.A.
1974	45.2	14.7	N.A.	N.A.
1975	43.9	14.6	N.A.	N.A.
1976	44.2	13.9	N.A.	N.A.
1977	44.3	15.4	N.A.	N.A.
1978	45.3	15.0	N.A.	N.A.
1979	47.0	14.2	N.A.	N.A.
1980	47.2	12.5	N.A.	N.A.
1981	47.7	10.2	N.A.	N.A.
1982	48.2	8.0	N.A.	N.A.
1983	48.1	6.2	N.A.	N.A.
1984	44.4	8.5	N.A.	N.A.
1985	44.7	9.0	N.A.	N.A.
1986	45.2	9.3	42.9	11.6
1987	45.6	10.2	42.6	13.1
1988	45.6	10.4	42.3	12.9
1989	46.2	10.4	43.4	12.8
1990	46.3	10.2	43.9	12.5

Source: Historical Tables, Budget of the United States; computed by the author.

Table 2

FEDERAL INCOME TAX REVENUES AS PERCENT OF GNP, 1946-1990

	Type of Tax			
	Current Law		Administration Plan	
Year	Individual	Corporate	Individual	Corporate
1946	8.0	5.9	N.A.	N.A.
1947	8.1	3.9	N.A.	N.A.
1948	7.9	3.9	N.A.	N.A.
1949	5.9	4.3	N.A.	N.A.
1950	5.9	3.9	N.A.	N.A.
1951	6.9	4.5	N.A.	N.A.
1952	8.2	6.3	N.A.	N.A.
1953	8.3	5.9	N.A.	N.A.
1954	8.1	5.8	N.A.	N.A.
1955	7.6	4.7	N.A.	N.A.
1956	7.8	5.1	N.A.	N.A.
1957	8.2	4.9	N.A.	N.A.
1958	7.8	4.5	N.A.	N.A.
1959	7.7	3.6	N.A.	N.A.
1960	8.2	4.3	N.A.	N.A.
1961	8.1	4.1	N.A.	N.A.
1962	8.3	3.7	N.A.	N.A.
1963	8.2	3.7	N.A.	N.A.
1964	7.9	3.8	N.A.	N.A.
1965	7.4	3.9	N.A.	N.A.
1966	7.7	4.2	N.A.	N.A.
1967	7.9	4.4	N.A.	N.A.
1968	8.3	3.4	N.A.	N.A.
1969	9.6	4.0	N.A.	N.A.
1970	9.3	3.4	N.A.	N.A.
1971	8.4	2.6	N.A.	N.A.
1972	8.4	2.8	N.A.	N.A.
1973	8.2	2.9	N.A.	N.A.
1974	8.6	2.8	N.A.	N.A.
1975	8.3	2.7	N.A.	N.A.
1976	8.0	2.5	N.A.	N.A.
1977	8.5	2.9	N.A.	N.A.
1978	8.7	2.9	N.A.	N.A.
1979	9.2	2.8	N.A.	N.A.
1980	9.5	2.5	N.A.	N.A.
1981	9.9	2.1	N.A.	N.A.
1982	9.8	1.6	N.A.	N.A.
1983	9.0	1.1	N.A.	N.A.
1984	8.3	1.6	N.A.	N.A.
1985	8.5	1.7	N.A.	N.A.
1986	8.5	1.8	8.0	2.2
1987	8.6	1.9	8.0	2.5
1988	8.8	2.0	8.1	2.5
1989	9.0	2.0	8.3	2.4
1990	9.0	2.0	8.5	2.4

Source: *Historical Tables, Budget of the United States*; computed by the author.

Table 3

NET INTEREST AS PERCENT OF GDP OF NONFINANCIAL CORPORATIONS, 1946-1984

Year	Percent
1946	0.7
1947	0.7
1948	0.7
1949	0.7
1950	0.6
1951	0.6
1952	0.7
1953	0.7
1954	0.8
1955	0.7
1956	0.7
1957	0.9
1958	1.1
1959	1.2
1960	1.3
1961	1.4
1962	1.4
1963	1.4
1964	1.5
1965	1.5
1966	1.7
1967	1.9
1968	2.0
1969	2.4
1970	3.0
1971	3.0
1972	2.8
1973	3.0
1974	3.6
1975	3.5
1976	2.9
1977	2.8
1978	2.9
1979	3.1
1980	3.7
1981	3.9
1982	4.1
1983	3.6
1984	3.7

Source: Survey of Current Business, various numbers.

STATEMENT OF DR. NORMAN B. TURE, PRESIDENT, INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION, WASHINGTON, DC

Dr. **Ture**. Mr. Chairman, I am delighted to be here, and I want to commend you and the committee for structuring this hearing in this form. I do hope that we live up to your expectations.

I am particularly pleased to have the occasion to do something that I seldom have done in the recent past, and that is to agree virtually wholeheartedly with Martin Feldstein. I associate with virtually all of his observations, but rather than address my remarks on the subject of the specific proposals in the President's tax reform package, I should prefer to do so in more general terms, and I hope the committee will indulge me. I think there are two issues posed by the question to which these hearings are addressed: Should the corporate sector bear a greater percentage of the income tax burden. One of these is the equity issue, and the other are the economic issues. Let me very summarily tick off my views with respect to both of them.

The equity issue has certainly gotten a lot more attention in the press, perhaps as well in the Halls of Congress. I think that is regrettable because equity is certainly—at least with respect to corporate income taxation—an almost impossible issue to deal with. In my judgment, there is no meaningful or operational equity standard which can be applied with any rigor at all to corporations as taxpayers. It is a truism, perhaps is a tired truism, but nevertheless, I think, a valid one, that corporations do not pay taxes—they merely collect them. Only real, living people pay taxes ultimately, and they pay corporation income taxes ultimately either in their role as shareholders in the corporations, as employees of the corporations, or as customers of the corporations, or as all three.

None of us know with any precision what the ultimate distribution of these liabilities among these individuals wearing one or another of these hats may be. Certainly, corporate financial officers and comptrollers and their transfer agents have no way of knowing who ultimately among those three groups and in what proportion will bear the corporate income taxes that the Internal Revenue Code assigns, but we should, before we proceed any further, recognize that ultimately the question, "Should the corporate sector bear a greater percentage of the income tax burden" really is a question of should people as shareholders, as employees, as customers of corporations bear more taxes in a disguised form? I think on any equity basis the unequivocal answer to that question has to be "no".

I think if we did know with any degree of precision how these liabilities which we impose on corporations are distributed among individuals wearing one or another of these hats, we would be at a loss to find any criteria of equity with which that distribution conformed. There is, therefore, in my judgment, no basis for establishing what a fair share of the aggregate income tax burden that should be borne by corporations could possibly be. Nor can I come up with anything that would be useful to you—certainly, it isn't useful to me—for determining what the fair share to be borne by any one corporation should be.

It seems to me this is a question which really presupposes a set of premises about what happens to the corporate income tax—premises that are in conflict with reality. So, I think there is no basis for determining how much of the tax load—which is ultimately borne by individuals in their capacities as savers, workers, or consumers—should be collected from them by corporations.

I think both fairness and efficiency in tax collection call for no income tax on corporations—they are not good tax collectors—but only on shareholders with respect to the income generated in corporations. Schemes to achieve that result have been developed over the recent past and have been delineated in one form or another. I commend to your attention blueprints for basic tax reform, produced by the Treasury Department and released in 1977, the first part of which details very carefully one such scheme for collecting tax from shareholders on the income generated in corporations. In the context of an income tax, therefore, it seems to me the only acceptable guide for equity and efficiency is to structure the corporation tax as withholding of shareholders' taxes on retained earnings. I would prefer, if it were at all possible, to avoid that responsibility as well.

Let me quickly go through the economic issues that I think are raised by the question to which the hearings are addressed. One cannot look at the corporate income tax and say it is a harmless levy, which seems to be implied by many of the suggestions that we should increase the amount of it. The corporation income tax is an incremental layer of tax on the returns on saving undertaken by individuals. It therefore has the effect of raising the cost of saving and raising the cost of capital, the consequences of which will be that there will be less capital committed to corporate enterprises than there otherwise would be. And as a result of that, the capacity of corporations to produce goods and services will be less than it otherwise would be. In addition, by virtue of the fact that there is less capital in the corporate community to be associated in the production process with employees, unless the laws of production that have been valid and applicable since economic activity first began on this planet have been repealed, what this means is that labor's productivity is less than it otherwise would be, that the demand for labor services is less than it otherwise would be, that real wage rates are lower than they otherwise would be, and that total employment is lower than it otherwise would be in the corporate sector. This means, in time, that either there is unemployment and lower aggregate output or that there is an uneconomical and inefficient shift of labor and capitol resources into the noncorporate sector. In any event, the overall effect on the economy as a whole has to be a loss of efficiency, a loss of productivity, a loss of output capacity, a loss of real income, and a loss of employment. It seems to me that those who propose to increase the share of total income taxes collected from corporations should bear in mind this adverse economic effect and should be very, very conscious of the cost of that additional burden. Thank you.

The **Chairman**. Thank you. Dr. Goode.

[The prepared written statement of Dr. Ture follows:]

Should The Corporate Sector Bear A Greater Percentage Of The Income Tax Burden: A Con Position

Presented by

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to

Committee on Finance

U.S. Senate

June 18, 1985

Summary

I. The Equity Issue

  A. No meaningful, operational equity standard applicable to corporations as taxpayers.

    1. Corporations collect taxes but do not pay them.

      a. Only real people pay all taxes

        (1.) Shareholders

        (2.) Employers

        (3.) Customers

      b. Ultimate distribution of these liabilities not known or controlled by either corporate management or tax law makers.

      c. Ultimate distribution of these liabilities would conform only by rarest chance with accepted standards of fairness.

    2. No basis for establishing a "fair share" of income tax burdens to be "borne" by corporations, in the

aggregate, or by any one corporation.

- a. No basis for determining how much of the tax load, ultimately borne by individuals in capacities of savers, workers, consumers, should be collected by corporations.
- b. Fairness and efficiency in collection call for no income tax on corporations but only on shareholders with respect to income generated in corporations.
- c. In the context of an income tax, the only acceptable guide is to structure corporation tax as withholding of shareholders' taxes on retained earnings.

II. The Economic Issues

- A. The corporation income tax increases tax bias against saving.
  - 1. Basic income tax bias against saving.
    - a. Income tax on current income that is saved.
    - b. Income tax on income that saving produces.
  - 2. Coporation income tax is additional layer of tax on saving committed to corporations'capital.
    - a. Corporate income tax on income produced by saving committed to corporations.
    - b. Individual income tax on after-tax corporations' income distributed to shareholders.
    - c. Corporate income tax on income produced by retained earnings.

- d. Accrual of individual income tax liability on retained earnings.

3. Shifting and incidence of corporation income tax.
    - a. Impact on cost of capital and stock of capital
        - (1.) Corporate
        - (2.) Noncorporate
    - b. Effect on capital: labor ratio
        - (1.) Corporate sector
        - (2.) Noncorporate sector
    - c. Effects on labor productivity, real wage rates, employment, and output.

STATEMENT OF DR. RICHARD GOODE, GUEST SCHOLAR, THE BROOKINGS INSTITUTION, WASHINGTON, DC

Dr. Goode. Thank you, Mr. Chairman. I would like to begin by saying that, although I am a guest scholar at the Brookings Institution, I appear in my personal capacity today and do not pretend to speak for the trustees, officers, or staff of the Brookings Institution. My position basically is that the corporation income tax should have a significant role in the revenue system, and I think that the tax bill should aim at producing at least as much revenue from that source as the President's plan and preferably considerably more. I differ from the President's plan in thinking that that additional revenue should not be used to finance a further reduction in individual income taxes but should be applied to the reduction of the deficit. I think there are several reasons why corporations might appropriately be called upon to pay a larger share of the Federal revenue.

First, as has been pointed out, there has been a big reduction in the share of Federal revenue from the corporation income tax. I agree fully that there is no objective test as to what the proportion should be, but I note there has been a sharp reduction in the share, a reduction in relation to GNP, and a reduction in the effective tax rate on corporate profits. Second, the present combination of ACRS and the investment tax credit results in highly unequal effective tax rates on different kinds of investment. On plausible assumptions about future inflation and interest rates, the effective tax rate on a large part of equipment is actually negative, representing a subsidy. Inequalities in taxation also occur because of special provisions that affect financial institutions, construction, oil and gas, and so on. The results are unfair and economically inefficient. I think that the reforms of corporate taxes should aim at lowering excessive rates but also raising the rates on the undertaxed sectors to an acceptable average. A third point is that a higher effective corporate income tax is needed, I think, to prevent shareholders from escaping tax on retained profits and also to tax nonresident shareholders. A fourth point is that increased corporate taxation is needed to raise revenue. The President's plan, as you know, calls for some $118 billion in additional revenue from corporations over the next 5 fiscal years. The Treasury plan of last November called for $165 billion over that period. The President and the Treasury Department believe that a substantial amount of revenue could be obtained from the corporation income tax without significant harm to the economy, and I agree. I just disagree about the application of that revenue. A fifth point is that although the corporation tax is not an ideal tax, it is superior to the Social Security payroll taxes, which are the second largest source of Federal revenue and which burden low-income workers much more than the income tax does. The corporation income tax is also superior in my judgment to a sales tax, which may be adopted if sufficient revenue is not obtained from the individual income tax and the corporation income tax. Unlike the payroll taxes and the sales taxes, the corporation income tax is a broadly progressive element in the tax system. The decline in the contribution of the corporate tax is an important factor in the virtual disappearance of overall progressivity in the entire tax system over the past 20 years. Sixth point: The public believes that corporations should be taxed. Past reductions in the corporation income tax have contributed to the loss of respect for the tax system. Failure to increase corporate taxes at this time would be perceived as a capitulation to special interests, in my judgment. These are very general remarks, Mr. Chairman. I would be happy to respond on particular points in the President's plan during the discussion period. Thank you.

[Dr. Goode's prepared written statement follows:]

ROLE OF THE CORPORATION INCOME TAX

Richard Goode[*]

(Principal points to be made in initial statement before the Senate Finance Committee, June 18, 1985)

The corporation income tax should produce a larger share of federal revenue for several reasons.

1. The share of the corporation income tax in federal budget receipts has declined sharply--from about 27-28 percent in the mid-1950s to about 8-9 percent in the mid-1980s. The decline is due mainly to more rapid capital cost recovey allowances, the investment tax credit, and increased reliance on debt finance in a period of high nominal interest rates.

2. The present combination of ACRS and ITC results in highly unequal effective tax rates on different kinds of investment. On plausible assumptions about future inflation and interest rates, effective tax rates are negative for a large part of investment in equipment. Inequalities of taxation also occur because of special provision benefiting financial institutions, construction, and oil and gas. The results of unequal taxation are unfair and economically inefficient. Reform should aim at narrowing differences in effective tax rates and establishing a reasonable average level by raising rates on the undertaxed sector and lowering rates on the overtaxed sector.

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[*] Richard Goode is a guest scholar at the Brookings Institution. The opinions expressed are his personal views and should not be ascribed to the trustees, officers, or staff members of Brookings.

3. A higher average effective rate of corporation income tax is needed (a) to prevent shareholders from escaping tax on retained profits and (b) to tax nonresident shareholders.

4. Increased corporate taxation is needed to raise revenue. The President's plan calls for $118.5 billion in additional revenue from corporations over the five fiscal years 1986-90. Treasury One (the November 1984 report of the Treasury Department to the President) proposed increases in corporate taxes of $165 billion over that period. The President and the Treasury Department believe that a substantial amount of additional revenue can be obtained from the corporation income tax without significant harm to the economy. I agree. In my opinion, the additional revenue from the corporate tax should be devoted to reducing the budget deficit rather than to financing a reduction of the individual income tax. If, however, the individual income tax is reduced as much as the President recommends, it will be essential to raise at least the amount he proposes from corporations to prevent tax reform from becoming a big revenue reduction, which we cannot afford.

5. Although the corporation income tax is not an ideal tax, it is superior to the social security taxes, which are the second largest source of federal revenue and which burden low-income workers much more than the income tax does. The corporation income tax is also superior to a sales tax, which may be adopted if sufficient revenue is not obtained form the individual income tax and the corporation income tax. Unlike the payroll taxes and a sales tax, the corporation income tax is a broadly progressive element in the tax system. The decline in the contribution of the corporate tax is an important factor in the virtual

disappearance of overall progressivity of the entire tax system during the past twenty years.

6. The public believes that corporations should be taxed. Past reductions in the corporation income tax have contributed to the loss of respect for the tax system. Failure to increase corporate taxes at this time would be perceived as a capitulation to special interests.

The CHAIRMAN. Let me say again to the members that are here that we are trying a slightly different format today, and I have invited the witnesses to interrupt our questions if they want, or for us to interrupt each other. This is more a debate format than it is the structured format we have used before. And if it works, we may try it again. If not, we won't. Dr. Minarik, let me start with you. Don't businesses--and I mean that in both the corporate and individual sense, because I suppose we can structure the Code in such a way to encourage people to operate it an individual capacity rather than a corporate capacity--won't all businesses similarly situated and assuming that they are not faced with foreign competition--won't businesses similarly situated try to pass along all costs in the form of prices, whether it is a corporate profits tax, a business and occupations tax, wages, or anything else, if they can?

Dr. MINARIK. The nature of the tax has a very substantial effect on whether or not tax can be passed on. In the first instance, corporations are going to sell their output under such conditions that they can make the most profit they possibly can, one would assume. If the taxes were then changed such that a corporation had to pay more tax, depending on the conditions and the way that the tax was imposed, there would not, in most likelihood for most taxes, not be an opportunity for the corporation to get more money out of its customers.

The CHAIRMAN. I don't understand why. Let's assume you are in the restaurant business, and you have got $1,000 invested, and you would like to make 10 percent a year after costs. You would like to make $100 if you could. If you increased the profits tax on all restaurants by the same amount—say a 50-percent surtax—isn't the tendency going to be for all of them to raise the costs of their meals in order to let them end up with the 10 percent at the time they are done with all of their costs?

Dr. TURE. Mr. Chairman, they may indeed try to raise the price of their meals, but they will not succeed in passing on the tax except insofar as the demand for those meals is highly inelastic with respect to its price. I don't think this properly captures the way in which the corporate income tax or any such levy, in fact, is transmitted into higher prices. I think the way in which that occurs is because that tax bears on one or another of the inputs which the corporation uses. Primarily, it bears on capital inputs, and by raising the cost of using capital, it simply means there will be less used. And again, by virtue of the fact that the laws of production still exist, with less capital input, there is less output. And with less output, prices will be higher.

The CHAIRMAN. I understand the inelasticity argument, and I suppose at some stage you can raise the taxes high enough that they go out of business, that they simply cannot charge for their product what the market will bear. But what difference does it make to the restaurant owner whether we increase their corporate profits tax $100 or their property tax $100?

Dr. MINARIK. It depends on the market in which they are operating and who their competitors are.

The CHAIRMAN. But if it is an identical tax increase on all restaurants, I would assume that if you were in the MacDonalds, Wendy's, and Big Boy field, you are roughly competing for the same type of trade and that the effect would be identical on all of you, wouldn't it?

Dr. **Minarik**. Well, they are also competing with food at home, Mr. Chairman, which is another——

The **Chairman**. I understand that.

Dr. **Minarik**. But there are big differences in the profit margins——

The **Chairman**. My question is: What difference does it make what the form of the increase in the costs is to them, whether it is a property tax or a corporation tax?

Dr. **Ture**. In the context in which you raised the question, I think you have answered it. Both of those taxes are taxes on the use of capital inputs, and if they are the same amount of taxes over a reasonable period of time, they will have the same effect. It will be negative.

The **Chairman**. What taxes are not?

Dr. **Ture**. Oh, you might say what about the employers' share of FICA? Indeed, the employer has a liability—the legal liability—for discharging that, but I think most economists who have looked at this matter agree that that tax is paid ultimately by labor services.

Senator **Bradley**. But Dr. Feldstein concluded something a little differently in his own testimony today about the impact of the FICA tax.

Dr. **Feldstein**. I don't think I did.

Senator **Bradley**. Didn't you say the effect of the FICA tax was to account for the drop in the total corporate tax dollars taken in?

Dr. **Feldstein**. Yes. What I was saying in the testimony was that if you ask why the corporate tax as a share of total Federal taxes has gone down so much, one of the obvious reasons is that FICA taxes have grown dramatically.

Senator **Bradley**. So, you are saying they are paying their tax in another way?

Dr. **Feldstein**. No. I am really just saying that—I am not saying that that tax is borne by corporations. I am simply saying that if you take FICA taxes from 2 percent of GNP to about 5.5 percent of GNP, then obviously the share of total Federal taxes that comes from the corporate income tax as such is going to come down. I was making a more arithmetic point than anything else.

Senator **Bradley**. Oh.

Dr. **Feldstein**. Can I try to answer—make another stab at your question, Senator?

Senator **Bradley**. OK.

Dr. **Feldstein**. It is not what tax is levied—what form of tax is levied on the restaurants, but how the form of the tax affects their competition. When I decide whether to eat out or to spend those dollars buying some other products, the relative prices of restaurant services and of other kind of products goods or services that I might buy will be affected—that relative price will be affected by the form of the tax.

The **Chairman**. I understand that.

Dr. **Feldstein**. And so in that sense, it matters to the restaurant owner whether you levy a tax on labor services, which are a large part of his costs, or on capital, which may be a relatively small part of his costs, and vice versa for somebody in the capital intensive industry.

The **Chairman**. Let me ask one more question and then we will open it up here. I don't yet understand though—now, let me rephrase this. I understand what proportion of it is cost, and maybe a property tax is 5 percent of the restaurant owner's costs and labor is 50 percent of their costs, but to the extent you raise all restaurants' costs 5 percent by increasing the property tax, I assume that you might run onto a few individuals who used to eat at Sir Walter Raleigh's who now will eat at MacDonalds. They can't afford to eat at Sir Walter Raleigh's. But short of forcing people out of eating out——

Dr. **Feldstein**. That is the key. That is exactly the point. I mean, I think what most economists would say is that if you raise the tax in a way that falls disproportionately on restaurants—which the corporate income tax would not—but if you did it in a way that fell disproportionately on restaurants, relative to the maker of toasters, people would cut down on their consumption of restaurant services. And that is why they would be hurt.

Dr. **Goode**. Mr. Chairman, may I comment briefly on this? I have a slightly different slant. It seems to me that an increase in the corporation income tax will not affect all restaurants the same. There are big differences in the profit margins, I assume, that restaurants experience. Hence, unlike the chairman's presumption that there would be an equal tax on all the restaurants, the tax would differ from one to the other. And that would prevent the more profitable restaurants from being confident that they could pass along the tax. Another point is this: If the restaurants could raise their prices and increase their profits, why don't they do so regardless of the rate of tax? All the corporation income tax does is take away some of the profits that they earn. If they could increase their profits before tax by raising prices, they would always be left with more profits after tax.

The **Chairman**. Senator Bentsen.

Senator **Bentsen**. Let me start you on another phase of this thing. Dr. Minarik was referring to the fact that if you favor one sector over another, you have got yourself an industrial policy, and I think you do. Whether you do it or not, you have chosen in one manner or another to influence it. I can understand our favoring one sector over another if we had no foreign competition, but when I look at a situation where capital cost is much cheaper in some competing country that is sending products into ours, then I ask what is wrong with having an industrial policy that gives an incentive for the modernization of the productive capacity of this country in those items that are competitive? And I would like to ask Dr. Feldstein or any one of you to speak to that point.

Dr. **Feldstein**. If we didn't have any taxes on capital income at all—obviously a counterfactual proposition—but if we didn't have any and you said: "But look abroad—foreigners are able to get capital more cheaply than American firms. Shouldn't we tax households, tax workers in order to subsidize capital so that our firms are more competitive?" I would say: "No, that would cause a misuse of capital." It would mean, a misuse of the taxing system that would lead to an inefficient use of resources. But we are not in that starting position. We are in a position where we do raise the costs——

Senator **Bentsen**. I am not raising that point. Dr. Feldstein. I am sorry. Let me try to be briefer. What I am really saying is that there is an argument against subsidizing American firms to make them more competitive against foreigners, but we are really not talking about subsidizing American firms. We are talking about reducing the tax burden on American firms in an environment in which there is that foreign competition. And in that context, I agree with the thrust of what you are saying—that we don't want to put an extra burden on American corporations which will simply drive them out of production and distort the production into foreign markets.

Senator **Bentsen**. Dr. Minarik, you might argue another point of view, and I would like to hear that because I am in sympathy with this point of view, but I want to understand the argument against it.

Dr. **Minarik**. Senator, I would suggest that there are two different ways in which you could say that the tax system could subsidize modernization. One way would be to say that you are going to give a tax incentive to particular kinds of capital. That is what we do presently with the investment tax credit. That is what we do in the accelerated cost recovery system. I would frown on that in that it makes the Tax Code—it puts the Tax Code in the position of making judgments about what kind of capital we should invest it——

Senator **Bentsen**. Of course, it does, but that is our competition, and that is what we are up against. And if we had our borders sealed, then I would buy your point of view, but I don't see how you compete against some of the others that don't put that heavy a burden on the manufacturing capacity.

Dr. **Minarik**. I am not willing to concede that that is what our competitors are doing. I don't know for a fact that many of our competitors are saying that they should buy—that their firms should buy particular kinds of machines and not other kinds of machines, which is what we do in ACRS, and I don't think I am prepared to concede that many of our competitors say you should buy machines but not structures.

Dr. **Feldstein**. That is a factual question there. I mean, the fact is that the Japanese do have a specific tax subsidy for robotics. The Europeans have more favorable treatment for equipment than they do for structures. So, we are really paralleling foreign tax treatment by our own current rules.

Dr. **Ture**. Senator Bentsen, I think what is really at issue is whether or not it is good or bad policy to use tax instruments in a highly selective way to favor one particular type of capital versus another. The charge that you have heard from the left-hand side of the table is that several of the provisions of existing law do just that. I think that that charge is without much merit. Provisions like ACRS and ITC somewhat ameliorate the otherwise untoward bias of our income tax structure against capital, across the board and particularly against long-lived capital that takes the form of machinery that is going to be around for a while and the structures that house that. Now, I think there is a great deal to be said in defense of those provisions. The kind of analytics that my organization has performed on this suggests that, instead of spreading the effective tax rates, ACRS and ITC combined have, in fact, reduced effective tax rates over most equipment classes.

The Chairman. I am curious now. Are you saying that if we had no ACRS, if we just had a normal depreciation, that that would be an industrial policy basically—and a corporate profits tax, the same percentage on all profits—that would be a tilt toward wholesale trade, retail trade, noncapital intensive businesses?

Dr. TURE. Right on the money. Right on the money, Mr. Chairman. Absolutely. If you look at—again, I am referring to the kind of analytical work that IRET has done on this, and I will be happy to supply that for the record, what you will find is that using the alleged economic depreciation which the Treasury had proposed in Treasury I last November—what you find is that you get an enormous spread in effective tax rates—very low at the short end of the capital asset distribution and very, very high with respect to structures and other long-lived equipment.

[The IRET analytical report follows:]

ACRS, ITC, AND TAX NEUTRALITY

SUMMARY

The Economic Recovery Tax Act (ERTA) of 1981 provided a major improvement in the tax system by replacing the Asset Depreciation Range depreciation system of prior law by the Accelerated Cost Recovery System (ACRS). Together with an increased investment tax credit (ITC), ACRS reduced the tax bias against saving and investment in depreciable facilities in general and narrowed the differential in effective tax rates on the income produced by different kinds of depreciable capital. The Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982 retreated from these advances toward tax neutrality. The current proposals for repealing the ITC and ACRS, replacing the provisions with a depreciation system based on much longer write-off periods, would further increase the tax bias against investment in depreciable facilities and result in serious tax distortions of the cost of capital and its allocation. Constructive tax reform calls, instead, for moving closer to true expensing of capital outlays.

Many of the current tax restructuring proposals would eliminate the Investment Tax Credit (ITC) and replace the Accelerated Cost Recovery System (ACRS) with a depreciation system based on significantly longer write-off periods. The current arguments against these capital recovery provisions are much the same as those that in 1982 led to the significant curtailment of ACRS in the Tax Equity and Fiscal Responsibility Act (TEFRA): ACRS and ITC are too generous and represent a subsidy for investment in eligible assets; and ACRS and ITC result in widely differing rates of tax on the returns to different kinds of capital, distort capital markets, and have induced capital movement into uneconomic activities.

There should be no argument about the desirability of achieving a tax system which is as nearly neutral as possible, which neither penalizes nor subsidizes investment in general and which does not distort market signals about the costs of and returns on alternative forms of investment. At issue is whether the claims that ACRS and ITC fail to meet this neutrality test are correct.

In fact, an objective assessment of the 1981 ACRS and ITC provisions show that they were major improvements in both respects; they reduced the then existing bias against saving invested in durable production facilities and narrowed the differentials in tax rates among different kinds of depreciable capital.

The ACRS provisions and the liberalization of the ITC enacted in the Economic Recovery Tax Act of 1981 (ERTA) aimed at reversing the slowdown in the growth of the U.S. industrial base. For the five years ending in 1979, increases in real net business fixed capital averaged just over 2 percent of net national product, one-half the rate for the late 1960s. Numerous factors contributed to that slowdown, chief among which was the escalating cost of capital attributable to the basic income tax bias against saving and capital formation, the inadequacy of depreciation allowances to offset that bias, and the intensification of that tax penalty by inflation. High inflation had caused a large discrepancy between the historic and current replacement costs of investment goods. In real terms, the value of the total depreciation deductions allowable with respect to a given amount of depreciable facilities was a fraction of the expenditures incurred for those assets. As a consequence, real marginal tax rates on the net returns on depreciable property were substantially higher than the statutory rates. This in turn elevated the cost of committing saving to depreciable capital.

ERTA made three major changes in cost recovery to address this problem.[1] Under ACRS assets are written off over periods largely independent of any notion of useful life. ACRS established four cost recovery periods—3, 5, 10, and 15 years—depending on the type of property, with the 15 year category reserved for all real property not designated as 5 or 10 year class property. In general, capital cost recovery was to be based on 150% declining balance for property placed in service in the years 1981 through 1984, 175% declining balance for property placed in service in 1985, and 200% thereafter.

Second, the ITC rate was increased for most eligible property. Under prior law, property with a useful life of less than 3 years obtained no ITC, that with useful lives of 3 or 4 years got a credit of 3½ percent, that with lives of 5 and 6 years got a 6⅔ percent credit, while property with a useful life of 7 or more years got a 10 percent ITC. Under ERTA, 3-year property got a 6 percent ITC and all other eligible property was given a 10 percent cedit. ERTA also extended eligibility for the ITC to certain kinds of property formerly excluded from the credit's application. In addition, it extended the period of years over which unused credits could be carried forward before being lost.

The third major feature of the 1981 capital recovery provisions was the safe-harbor leasing provision. Safe-harbor leasing created a mechanism by which firms that were currently unable to use their investment credits and ACRS deductions could transfer these rights to firms that could take advantage of them. It signaled recognition of the fact that the effectiveness of ACRS and the liberalized ITC in offsetting the income tax bias against investment in durable production facilities depended on the extent to which taxpayers could actually utilize these provisions currently, rather than having to defer their benefits, possibly for extended periods of time.

TEFRA made significant and serious changes in the capital cost recovery provisions. Among its other features, TEFRA instituted partial basis adjustment for the ITC, stopped the phase-in toward the 200% declining balance recovery method, limiting the recovery rate to the initial 150% rate, and eliminated the safe-harbor leasing provisions. These changes occurred amid charges that the recovery provisions were too generous and that they represented an investment subsidy which varied widely among types of property and situations of taxpayers, hence distorted the allocation of capital.

To address this allegation it is necessary first to delineate the conditions which must be met for neutral tax treatment.

TAX NEUTRALITY

By neutrality, we mean that a tax does not alter the relations among prices and costs that would prevail in the absence of taxes. Suppose, for example, that without any taxes the price of a pound of apples is half that of a dozen oranges, but when a particular tax is imposed, the prices are the same. Obviously, the tax has increased the price of apples relative to that of oranges; except under extraordinary conditions, this relative price change will lead people to buy fewer apples compared with oranges than they would have if the tax had not been imposed.

THE BASIC INCOME TAX DISTORTION

In this sense, the income tax is unneutral with respect to consumption, on the one hand, and saving and investment, on the other. It raises the cost of future income compared with that of current consumption. To see this, compare these relative costs in the absence and presence of an income tax.

To begin with, consider a world with no taxes where one dollar can either be used to buy an asset which produces a perpetual income stream of 10 cents a year or which can be used to purchase one dollar of current consumption. If we now impose an income tax at, say, 50 percent, we alter the relative price of consumption and future income. The dollar of pre-tax income now buys 50 cents of consumption goods. That same dollar now can buy an income stream of 5 cents, which itself is taxed, leaving a net income stream of 2.5 cents. The tax has doubled the number of pre-tax dollars needed to maintain the level of consumption but quadrupled the number of pre-tax dollars needed to purchase an equivalent stream of future income. It has, therefore, doubled the cost of future income relative to the cost of current consumption. The higher the tax, the greater the distortion in favor of current consumption.

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[1] ERTA did not aim solely at offsetting the erosion of capital recovery allowances by inflation. Its basic purpose was to reduce the inherent bias in the income tax against committing saving to investment in depreciable property.

INCOME TAX DISTORTION OF CAPITAL ALLOCATION

We can think of this fundamental bias of income taxes against saving and investment and in favor of consumption as a first-level unneutrality. In addition, however, insofar as it allows differing deduction, credits, exclusions, etc., the income tax is likely to alter the relative costs of acquiring or holding different kinds of capital. These differing costs of capital are likely to result in a different allocation of saving among alternative capital uses and a different composition of capital than if there were no taxes. These income tax induced differences in capital costs are conveniently designated second-level unneutralities.

Both first- and second-level unneutralities clearly impair the economy's efficiency. The first-level bias, by distorting saving-consumption choices, results in a smaller stock of capital, less production capability, and a lower standard of living than would prevail if the tax were more nearly neutral. And if we can fairly assume that the way people allocate their saving and investment in the absence of taxes would result in the most productive stock of capital, then the second-level distortions must also impose significant costs on the economy. Of the two, it should be clear, the first-level unneutrality, the basic income tax bias against saving and investment in general, must be the more costly.[2]

NEUTRAL TAX TREATMENT

Two alternative means to eliminate the basic bias against saving and investment are obvious from the above example: either exempt saving, i.e., expenditures for capital, from taxation while taxing the gross returns to capital, or tax the current income which is saved and invested and exempt all the returns to capital.

If current saving is excluded from the tax base, i.e., is "expensed," the dollar of current income that is saved and invested escapes the tax; the returns on the investment, however, are fully taxed so that the saved dollar produces 10 cents of income per year before tax and 5 cents a year after tax. In the alternate approach, the 50 cent tax on the dollar of current income leaves 50 cents to save and invest, producing 5 cents of income a year before tax; because no tax would be imposed on this return, it also provides 5 cents of income a year after tax. In either case, a dollar of current income that is saved bears the same burden as a dollar of income that is consumed; the trade-off between current consumption and future income is the same as if there were no tax.

Either approach, consistently applied, would be neutral in the second-level sense as well as with respect to the overall cost of saving relative to consumption. Indeed, either approach is virtually essential if neutrality of tax treatment among alternative forms of saving and investment is to be assured.

TAX NEUTRALITY WITH EXTENDED PERIOD WRITEOFF

The same neutrality conditions may be satisfied if, instead of either expensing saving or capital outlays or excluding investment returns from the tax base, tax deductions to recover the amount of saving or capital outlays are spread over time, provided that the present value of such deductions equals the amount saved and invested. Because at any positive discount rate, a dollar received a year from now is worth less than a dollar in hand today, the absolute or undiscounted amount of such deductions must be greater than the amount currently saved and invested, if their present value is to equal the amount of the current saving and investment. If the tax law limits the total undiscounted amount of capital recovery allowances to the amount saved and invested, the present value of these allowances must be less than the amount saved, and the capital recovery provisions must fall short of meeting the neutrality test.

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[2] For many years, much of the scholarly tax literature ignored the first-level unneutrality—the income tax bias against saving and investment in general—and concentrated on the second-level unneutrality—the effect of differential provisions in the tax law in distorting the allocation of capital. This may be likened to focusing attention on preventing petty theft while doing nothing to prevent grand larceny.

To illustrate, allowing the saver to deduct half of this year's saving against this year's income and half against next year's income will fall short of satisfying the neutrality condition. If the discount rate is, say, 10 percent, the present value of these deductions, per dollar of saving, is 87 cents; an additional deduction, the present value of which is 13 cents, would be needed to prevent the tax from increasing the cost of saving the marginal dollar of current income relative to the cost of consuming it. A further deduction of about 7½ cents each year would be needed to equate the value of the deductions over the two years to the current dollar of saving and investment. Total deductions would have to be $1.15. The longer the period over which the deductions are spread, the greater must be the absolute amount of the additional deductions. If the deductions are to be spread over three years, for example, each year's deduction would have to be 40.2 cents per dollar of saving, and the sum of the three years' deductions would have to be $1.21. An alternative correction would be to provide an additional deduction in the first year sufficient to make up the shortfall. In this example, an extra deduction of 14.3 cents would be needed.[3]

IS ACRS WITH ITC TOO GENEROUS? DOES IT INCREASE TAX DIFFERENTIALS?

With this framework we can evaluate the claims that ACRS with ITC (1) affords excessively generous capital recovery, at least for many types of capital, and (2) increases the tax differentials among different types of saving and investment, hence exacerbates second-level unneutralities.

In its simplest form, the test is whether the sum of the present values of the ACRS deductions plus a deduction equivalent in its effects on tax liability to the ITC equals, exceeds, or falls short of the amount of the investment. If the sum of the present values of these capital recovery deductions just equals the amount of the investment in the property on which they are allowed, the capital recovery deductions afford neutral tax treatment of that use of saving. If the sum of the present value is less than the investment, these deductions do not fully offset or neutralize the tax bias against that investment. If the sum of the present values exceeds the investment, the capital recovery provisions subsidize the investment. If the shortfall or excess as a percent of the investment is the same for all kinds of investment, the capital recovery provisions equally penalize or subsidize, respectively, all investment; the second-level neutrality conditions are satisfied even though the tax provisions fail to provide neutrality overall.[4]

The results of this test are shown in Table I, in part A with respect to the ACRS-ITC provisions, as enacted in ERTA, applicable to property put in service in taxable years 1986 and later. Part B of the table shows the test results after TEFRA's changes.

These results show that except in the case of 15-year real property, the original ACRS-ITC combination afforded a relatively close approximation of both the first and second level neutrality condition. At a given discount rate, the present value of the capital recovery provisions per dollar of investment is within a few cents of a dollar, significantly exceeding a dollar only in the case of 5-year property at the 4 percent discount rate, which implies little if any expected inflation. For longer-lived property, on the other hand, the ERTA provisions fall substantially short of satisfying the neutrality conditions, leaving a substantial tax penalty on saving invested in such capital and grossly differentiating the tax treatment of such investment relative to investment in shorter-lived properties. The penalty is particularly severe in the case of real property, for which the ITC is not available.

Again putting aside the 15-year recovery period property, the spread in the present value of recovery allowances per dollar of investment, at a given discount rate, is quite small—a maximum of 11.4 percent in the case of 5-year vs. 10-year property when the discount rate is 10 percent. At a 4 percent discount rate, the biggest spread is 5.7 percent, in the case of 5-year vs. 3-year property.

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[3] In this example, it is assumed that the investment is made at the beginning of the year and that the returns on it as well as the deductions are at the end of the respective years. This assumption is maintained throughout this discussion.

[4] There are three critically important qualifications to this conclusion: (1) the capital recovery allowances must begin at the time at which the costs of acquiring the property are incurred, not at a later date, e.g., when the property is placed in service; (2) the capital recovery allowances must be allowed in determining all of the taxes imposed on the returns on the investment in the property; and (3) the capital recovery allowances must be given full effect in the years in which they are allowed and claimed, not carried forward to some future years. If these conditions are not satisfied the test results will overstate the subsidy and understate the penalty. These qualifications are discussed at greater length below.

TABLE I.—PRESENT VALUE OF ACRS AND ITC-EQUIVALENT [1] DEDUCTIONS PER DOLLAR OF INVESTMENT, AT SELECTED DISCOUNT RATES

Recovery period (years)	Discount rate (percent)		
	4	8	10
A. ERTA provisions for property placed in service in 1986 and subsequent years: [2]			
3	$1.05	$.99	$.96
5	1.11	1.02	.98
10	1.06	.93	.88
15 (real property)	.77	.61	.55
15 (personal property)	1.01	.86	.80
B. TEFRA provisions: [3]			
3	$1.02	$.95	$.91
5	1.05	.95	.91
10	.99	.85	.79
15 (real property)	.77	.61	.55
15 (personal property)	.93	.76	.70

[1] The ITC-equivalent deduction is computed as the ITC rate divided by .46, the top marginal corporation income tax rate. The ITC rate for 3-year property is 6 percent, that for 5 and 10-year property is 10 percent. The 15-year recovery period class consists principally of real property not eligible for the investment tax credit. However, some 15-year property is eligible; the present value of the deductions for this property per dollar of investment is shown as 15 year personal property.

[2] ACRS deductions calculated with the 200 percent declining balance method, switching to sum-of-the-years digits; the half-year convention is used throughout.

[3] Assumes adjustment of basis for ACRS deductions equal to one-half of ITC. ACRS deductions are computed with the 150 percent declining-balance method, switching to straight line.

Against both the first-and-second-level neutrality criteria, ERTA's ACRS and ITC provisions represent a significant advance over the prior law's Asset Depreciation Range (ADR) provisions. The present value of the sum of ADR allowances and the ITC-equivalent deduction per dollar of investment in properties with various ADR midpoint lives is shown in Table II. The ADR lives shown in the table are representative of the kinds of production facilities for which ACRS provided the corresponding, much shorter recovery periods presented in the second column of the table.[5]

TABLE II.—PRESENT VALUE OF ADR [1] AND ITC-EQUIVALENT [2] DEDUCTIONS PER DOLLAR OF INVESTMENT, BY SELECTED ADR MIDPOINT LIVES (AND CORRESPONDING ACRS RECOVERY PERIODS) AT SELECTED DISCOUNT RATES

ADR midpoint life (years)	Corresponding ACRS recovery period	Discount rate (percent)		
		4	8	10
3	3	$1.00	$.93	$.90
10	5	1.04	.91	.85
18	10	.95	.78	.72
30 (personal property)	15	.81	.63	.57
35 (real property)	15	.61	.43	.37

[1] ADR deductions computed with the 200 percent declining balance method, switching to straight line; the half-year convention is used throughout.

[2] The ITC-equivalent deduction is computed as the ITC rate divided by .46, the top marginal corporation income tax rate. The ITC rate for 3-year property is 3⅓ percent, that for the other property shown is 10 percent.

Comparing the results presented in Table II with those in Table I.A. shows that (1) compared with the ADR–ITC combination, the present values of the ACRS–ITC capital recovery allowances per dollar of investment come much closer to meeting the first-level neutrality test; the present value of the ADR–ITC allowances generally fall substantially farther short of equality with the amount saved and invested; and (2) the ACRS–ITC provisions significantly reduced the spread in the present value of capital recovery allowances per dollar of investment which occurred in the case of the ADR–ITC provisions, hence were more nearly neutral among different kinds of capital in different uses.

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[5] Under the ADR system adopted in 1971, depreciable property was assigned to one of 144 property classes, identified by industry with some property type subclassification. A useful life was assigned to each of these property classes but the taxpayer was permitted to assign a life as much as 20 percent shorter or longer for purposes of computing the depreciation allowance. The depreciation deductions computed for purposes of this table were based on the 200 percent declining-balance method with a switch to straight line.

TEFRA, by limiting the write-off rate to 150 percent declining balance and reducing the basis for ACRS deductions by one-half the allowable ITC, significantly reduced the sum of the present values of ACRS and ITC-equivalent deductions per dollar of investment, except in the case of 15-year real property. For most personal property, TEFRA increased the tax penalty on investment in depreciable facilities, and in the case of 3- and 5-year property at the 4 percent discount rate, reduced the modest subsidy which ERTA had afforded. Moreover, TEFRA increased the percentage spread, at each discount rate, between the highest and lowest present values of capital recovery per dollar of investment. TEFRA, in short, entailed a significant movement away from both first-level and second-level neutrality.

The results in Tables I and II can be translated into the effective tax rates which apply to the returns on different kinds of capital; these tax rates are shown in Tables III and IV.

TABLE III.—EFFECTIVE TAX RATES UNDER ACRS BY RECOVERY PERIOD AND BY SELECTED DISCOUNT RATES [1]

Recovery period (years)	Discount rate (percent)		
	4	8	10
A. ERTA provisions for property placed in service in 1986 and subsequent years: [2]			
3	−4.6	1.1	3.8
5	−9.6	−2.0	1.4
10	−4.9	5.9	10.4
15 (real property)	20.0	33.4	38.5
15 (personal property)	−0.8	12.1	17.3
B. TEFRA provisions [3]			
3	−1.6	4.6	7.4
5	−4.4	4.0	7.7
10	1.2	12.9	17.7
15 (real property)	20.0	33.4	38.5
15 (personal property)	6.3	20.3	25.6

[1] See footnote 1, Table 1.
[2] See footnote 2, Table 1.
[3] See footnote 3, Table 1.

TABLE IV.—EFFECTIVE TAX RATES UNDER ADR BY SELECTED ADR LIVES AT SELECTED DISCOUNT RATES

ADR midpoint life (years)	Corresponding ACRS recovery period	Discount rate (percent)		
		4	8	10
3	3	0.1	5.7	8.2
10	5	−3.7	7.6	12.4
18	10	3.9	18.6	24.0
30 (personal property)	15	14.4	31.2	36.6
33 (real property)	15	33.0	48.9	53.9

As shown in the earlier discussion, tax neutrality requires that if income that is saved and invested is subject to the income tax, the income that is earned on the investment should be excluded from the tax base. If the capital recovery provisions in the income tax perfectly satisfy the neutrality criterion the effective tax rate on the income earned by the production facilities is zero. Any positive effective tax rate means that not only is the income which is used to buy the production facilities subject to tax, but the returns on that investment are also taxed; hence, the income that is saved is subject to a greater rate of tax than that which is consumed. In this case, the capital recovery provisions fall short of eliminating the income tax bias against saving. On the other hand, if the effective tax rate is negative, the capital recovery provisions are too generous, go beyond the requirements of neutrality, and subsidize the investment in the production facilities.

The effective tax rate on the returns on investment is properly defined as the percentage difference between (1) the present value of the pretax gross returns required if the present value of the after-tax gross returns are to just equal the amount of the investment, and (2) the present value of the gross returns that would be required if there were no tax. To illustrate this concept, suppose that a particular production facility costs $1,000 and is expected to contribute to production for five years in the amounts shown in column 2 of Table V. If there were no tax and if the discount rate were, say, 10 percent, the present value of these gross returns would be just equal to $1,000. If the gross returns were less than those shown, their present value would fall short of $1,000, and it clearly would not pay to buy the facility.

Next, suppose an income tax at a rate of, say, 40 percent is imposed on these gross returns less depreciation, in the amounts shown in column 3 of the table. Gross income after tax would fall to the amounts shown in column 6. The present value of the after-tax gross returns would fall to $903.23. If the investment of $1,000 is to be warranted, the present value of the after-tax gross returns must also be at least $1,000, but this will require an increase in the pretax returns to the amounts shown in column 9 of the table. The present value of that stream of required pretax gross returns is $1,161.23 (column 10). The effective tax rate is 16.12 percent, the percentage difference between $1,161.23, and $1,000, that is between the present value of the required pretax gross returns when the tax is imposed and the present value of the gross returns that would be needed if there were no tax.[6]

The effective-tax rates shown in Tables III and IV were calculated in the manner illustrated above. Against the standard of tax neutrality, they are to be interpreted as the extra burden imposed on current income that is saved and invested compared with the tax burden on consumption.

This extra burden clearly is significantly less under the ACRS and ITC provisions in ERTA than under the prior ADR system. Moreover, the spread in effective tax rates is also far less under ACRS than in the case of ADR. Against both standards of neutrality, ERTA's ACRS-ITC provisions represent a major improvement over prior law.

The TEFRA revisions must be seen as a significant step backwards in this respect. Not only did TEFRA increase effective tax rates for all types of property, it also increased the spread among those rates. It intensified the tax bias against saving and capital formation overall and at the same time enhanced the disparities in effective rates from one type of capital to another.

EFFECT OF OTHER TAXES ON EFFECTIVE TAX RATES

Earlier in this discussion, three factors were identified which qualify the evaluation of capital recovery provisions against the tax neutrality standard. Taking account of these factors significantly increases the effective tax rates under ACRS shown in Table III.

For one thing, the present value of the ACRS deductions and the ITC must be determined with respect to the time at which the costs of acquiring the property are incurred. For the most part, the ACRS deductions are first allowed for the taxable year in which the property is placed in service; the ITC is also claimed in that taxable yer. That is often a later taxable year than that in which the investment, or a part of it, is made; this is particularly likely to be true in the case of investment in properties which have an extended, multi-yer construction or manufacture period, during which the investor makes progress payments to the supplier of the capital facility. When this is the case, the ITC-equivalent deduction and the ACRS allowances must be discounted to the time (or times) at which the investment cost is incurred to determine whether the pressent value of these deductions equals, exceeds, or falls short of the amount of the investment.

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[6] In this example, the capital recovery provisions clearly fall short of providing neutral tax treatment. The present value of the depreciation deductions in column 3 is $758.15, a shortfall of $241.85 from the amount invested.

TABLE V.—DERIVATION OF EFFECTIVE TAX RATE

Year	Gross income pretax	Depreciation	Taxable income	Tax at 40 percent	Gross income after tax	Present value of gross income		Required pretax gross income	
						Pretax	After tax	Undiscounted amount	Present value
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
1	300	200	100	40	260	272.13	236.36	366.67	333.34
2	280	200	80	32	248	231.41	204.96	333.33	275.48
3	260	200	60	24	236	195.34	177.31	300.00	225.39
4	240	200	40	16	224	163.92	152.99	266.67	182.14
5	220	200	20	8	212	136.60	131.64	233.33	144.88
Total	1,300	1,000	300	120	1,180	1,000.00	903.33	1,500.00	1,161.23

A second condition is whether the ACRS deductions and ITC are allowed in determining all of the taxes which are imposed on the returns on the investment. There are practically no situations in which this condition is satisfied. When a corporation acquires depreciable property, for example, the ACRS deductions and the ITC are allowed only in determining the corporation income tax liability. Some or all of the income produced by the property is almost invariably subject to the individual income tax, to the extent the corporation pays dividends out of this income or the individual shareholder sells stocks in the company and realizes a capital gain reflecting the retention of part or all of the earnings produced by the property. The income in the hands of the corporation is also likely to be subject to state income tax; few state income taxes have capital recovery provisions which are the same as the ACRS and ITC. Insofar as dividends are paid from these earnings, moreover, the individual shareholders are also likely to be subject to state income taxes. Property taxes also apply; they may be treated as an income tax imposed on the capitalized value of the net earnings produced by the property. In short, the ACRS and ITC are taken into account in determining only a fraction of the taxes imposed on the income produced by eligible capital. This consideration must be given full weight in determining whether these capital recovery provisions subsidize investment.

The final condition is whether the ACRS and ITC are given full effect in the years in which they are claimed or whether their effect on tax liability is deferred until a later taxable year or years. This deferral effect occurs when taxable income before ACRS deductions is less than the amount of the ACRS deduction allowable in that year and/or when tax liability before the ITC is less than the amount of the credit. In computing the present value of the ACRS deductions and the ITC, therefore, only the respective amounts actually having effect on tax liability in each year should be taken into account.

The magnitude of the impact of these factors on the effective tax rates on returns to capital is indicated even if account is taken only of the effect of additional taxes payable on these returns. Table VI shows that even when the sum of the rate of all other taxes applied to the returns on depreciable capital is quite low, the overall effective tax rate is materially higher than it would be if, in reality, only the Federal corporation income tax at a rate of 46 percent were imposed.

For example, if other taxes are ignored, the effective tax rate on 3-year property under ERTA, as shown in part A of Table III, is −4.6 percent when the discount rate is 4 percent. If other taxes amount only to 5 percent, the effective rate on this property becomes 5.1 percent. With other taxes aggregating 15 percent, the effective rate becomes 32 percent.

TABLE VI.—EFFECTIVE TAX RATES ON RETURNS TO DEPRECIABLE PROPERTY, BY ACRS RECOVERY PERIOD AT SELECTED RATES OF OTHER TAXES AND SELECTED DISCOUNT RATES

Recovery period	Rate of other taxes (percent)	Discount rate (percent)	4	
			8	10
A. ERTA provisions for property placed in service in 1986 and subsequent years:				
3	5	5.1	11.4	14.4
	10	17.0	24.1	27.4
	15	32.0	40.0	43.7
5	5	−0.4	8.0	11.8
	10	10.9	20.3	24.5
	15	25.1	35.7	36.5
10	5	4.8	16.7	21.7
	10	16.7	29.9	35.5
	15	31.7	46.6	52.9
15(real property)	5	32.2	47.0	52.6
	10	47.2	63.7	69.9
	15	66.1	84.7	91.8
15(personal property)	5	11.0	23.6	29.3
	10	23.7	37.6	44.0
	15	39.5	55.3	62.4
B. TEFRA provisions:				
3	5	8.5	15.3	18.3
	10	20.8	28.4	31.8
	15	36.3	44.8	48.7
5	5	5.4	14.6	18.7
	10	17.4	27.6	32.2
	15	32.4	44.0	49.1
10	5	11.5	24.4	29.7
	10	24.2	38.5	44.4
	15	40.1	56.3	62.9
15(real property)	5	32.3	47.0	52.6
	10	47.2	63.7	69.9
	15	66.1	84.7	91.8
15(personal property)	5	17.2	32.5	38.4
	10	30.5	47.6	54.1
	15	47.2	66.5	73.9

For long-lived property, the effect is even more pronounced. For example, in the case of 15-year real property, for which no ITC is available, the effective tax rate is 32.2 percent when other taxes are 5 percent, compared with 20 percent when no other tax applies, at a 4 percent discount rate. At higher discount rates, this impact of other taxes is even more severe. And as part B of the table shows, the TEFRA revisions significantly enhanced this impact.

A major implication of these results is that even with the ITC, the ERTA capital recovery provisions fell short, almost across the board, of eliminating the tax bias against investment in depreciable property, because of the impact of other taxes on the net returns on such property. Stretching out recovery periods and/or reducing the ITC increases this adverse impact, particularly for long-lived property and at high discount rates.

CONCLUSION

When evaluated against a meaningful concept of tax neutrality, the adoption of ACRS and the changes in ITC in the 1981 ERTA represented a major improvement in the tax structure. The ERTA provisions significantly reduced the overall tax bias against investment in depreciable property and materially narrowed the differentials in effective tax rates among different kinds of property.

The TEFRA provisions pertaining to ACRS were a significant step backward in this report. Although not retreating all the way back to the ADR distortions, TEFRA increased the overall effective rate of tax on returns to depreciable property and widened the spread in the effective rates among assets.

When account is taken of the other taxes which are imposed on the income produced by depreciable production facilities, it is apparent that even the ERTA provisions fall considerably short of eliminating the income tax bias against channeling saving into depreciable capital formation. The simplest way to remedy existing deficiencies would be to provide for expensing of all depreciable capital outlays. Because other taxes apply to the returns on this capital and because differences between the timing of the investment and that of the effective expensing of the investment would very likely persist, some additional capital recovery allowance or tax credit would be needed to satisfy the neutrality tests. If tax policy is to move in the direction of reducing the distorting influences of taxes on the allocation of resources, this is the direction which changes in capital recovery provisions should take. Stretching out recovery periods and eliminating the ITC is the wrong way to go if efficient functioning of the free market system is an important objective of tax policy.

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"ACCELERATED," "REAL," AND "NEUTRAL" COST RECOVERY SYSTEMS IN AN INFLATIONARY WORLD

The Treasury Department's tax reform plan includes a proposal to replace the present Accelerated Cost Recovery System and Investment Tax Credit (ACRS–ITC) by an inflation-indexed, extended-life depreciation system, the Real Cost Recovery System (RCRS). Against the standard of neutral tax treatment of depreciable property with different cost recovery periods, however, RCRS is inferior to ACRS–ITC, even at inflation rates significantly higher than now prevail. The inflation-indexed Neutral Cost Recovery System (NCRS) included in the Kemp-Kasten FAST proposal would much more nearly satisfy the inter-asset neutrality criterion, at any rate of inflation, than either RCRS or ACRS–ITC. It would also effectively eliminate the prevailing income tax bias against investment in durable capital. It is an innovative approach to resolving the problem of the front-loaded ACRS–ITC without the adverse effects on the cost of capital in the RCRS.

INTRODUCTION: THE CAPITAL RECOVERY ISSUE

The recent emphasis placed on inflation indexing for capital recovery accounts has obscured the real issues in the design of capital cost recovery systems. As important as it may be for insulating cost recovery allowances against erosion by inflation, indexing cannot in and of itself transform an inadequate cost recovery system into an optimal one. Indexing can maintain the desirability of an already desirable system, its absence can make an otherwise efficient system fail upon implementation, but it can do no more than prevent a flawed system from becoming more undesirable. Even this last result can only be achieved if the indexing accurately accounts for the effect of inflation. Indexing of capital recovery, moreover, is not the only way to adjust for the effects of inflation.

With short recovery periods, in which the recovery allowances are greatest in the early years, a capital cost recovery system is less affected by inflation than a system with long recovery periods. The absence of indexing in such a system is, therefore, less of a liability than one might imagine.

The real issue concerns the adequacy of a capital recovery system in neutralizing the anti-saving, anti-capital formation basis inherent in income taxation. To be sure, indexing may well be a highly useful element of a capital recovery system in an inflationary environment. In itself, however, indexing does not address the main issue.

Two indexed recovery systems illustrate this point. The Real Cost Recovery System (RCRS) put forward by the Treasury Department in its "Tax Reform for Fairness, Simplicity and Economic Growth", and the Neutral Cost Recovery System (NCRS) advanced by the Kemp-Kasten "Fair and Simple Tax Act" as introduced in the 99th Congress both include indexing. While NCRS would be a major advance toward neutral tax treatment of investment in depreciable facilities, RCRS would be a major retreat.

The RCRS structure ostensibly is built on the concept of economic depreciation, i.e., the loss in the market value of the asset between the beginning and end of a period of time.[1]

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[1] This loss in market value, equal to the reduction during the period in the present value of the remaining income the asset is expected to produce, depends on a myriad of factors which

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The recovery periods under RCRS range from five to 63 years. The sum of undiscounted depreciation deductions before indexing is set at 100% of the expenditure on the asset. At the end of these recovery periods, 15 percent of the initial basis of the asset will remain unrecovered. These remaining amounts presumably are to be written off under some as yet unspecified method over some as yet unspecified periods of years.

NCRS, on the other hand, is a modification of the current-law Accelerated Cost Recovery System (ACRS). It extends the ACRS recovery periods from the present three to 18 years to a range of four to 25 years. NCRS also increases the nominal amount of recovery allowances so that, before indexing, their undiscounted amounts exceed 100% of the expenditure on the asset. For each recovery period, the increase is such that when discounted at a real discount rate of 3.5%, the present value of the allowances equal 100% of the expenditure on the asset. Both RCS and NCRS repeal the Investment Tax Credit.

The evaluation of these two proposals must consider two attributes of their structure: (1) how well does the system achieve the goal of neutrality between saving and investment vs. consumption, and (2) is the system consistent in its treatment of assets with different recovery periods for tax purposes, i.e., how neutral is it in its treatment of different assets. The first of these may be thought of as first-level neutrality; the second is designated second-level or inter-asset neutrality.

The Treasury Department's proposal does not seek to achieve first-level neutrality with RCRS, but it is claimed that this system would achieve neutrality in the treatment of all the different kinds of depreciable assets. This inter-asset neutrality goal may be expressed as that of imposing the same effective rate of tax on the returns on all such assets, irrespective of the recovery periods assigned to them. The effective rate of tax that is relevant for this purpose is defined as the percentage difference between (1) the present value of the pretax gross return on an asset required if the present value of the after-tax returns is to just equal the price of the asset, and (2) the present value of the gross returns that would be required to equal the price of the asset if there were no tax.[2]

INTER-ASSET NEUTRALITY

To meet this test of neutrality, an essential condition is that the present value of the capital recovery allowances must be the same for all assets. The present value of these allowances depends, obviously, on the rate at which it is appropriate to discount future amounts of income or expense. In general, the appropriate discount rate is one which takes into account both the real after-tax rate of return, adjusted for differences in risk, which prevails in the capital market, and the expected rate of inflation. A cost recovery system which is more nearly neutral than another system at one combination of real rate of return and expected inflation rate may be less nearly neutral if another combination of such rates prevails.[3]

To discern whether a given capital recovery system more nearly satisfies this neutrality condition than some other system, it is useful to evaluate the systems first on the assumption of a zero expected inflation rate but with differing real rates of return. By first evaluating inter-asset neutrality in a zero inflation world, it is possible to separate the underlying structure of the cost recovery system from the effect of the indexing provisions.

Table I presents the present value of cost recovery allowances, by asset class, in a zero inflation world under ACRS (with ITC), RCRS, and NCRS.[4] The results are

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have differing effects from time to time, asset to asset, and taxpayer to taxpayer. The notion that any cost recovery system prescribed for the income tax will come anywhere near close to measuring economic depreciation boggles the mind.

[2] This concept is illustrated in IRET's Economic Report No. 25, "ACRS, ITC, and Tax Neutrality," pp. 10–12.

[3] Neutrality is assured, on the other hand, irrespective of the real rate of return and expected inflation rate if true expensing is provided for all capital. True expensing requires fully effective write-off of the costs of acquiring capital as these costs are incurred; these write-offs must apply in the case of all taxes that are levied on the capital's returns. For a fuller explanation and discussion, see IRET's Economic Report No. 25, op. cit.

[4] It should be noted that these present value calculations differ from those used by the respective sponsors of the RCRS and NCRS proposals. In both cases they chose not to discount allowances available in the first year, possibly in the belief that since these would be reflected in quarterly tax payments they would be immediately available. In fact, each of those quarterly payments should reflect one quarter of the end-of-year tax liability, and hence only one quarter of the depreciation deduction. All of the calculations presented here discount the first year's deduction by a half year to approximate this series of deductions as they are realized. Subse-

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shown at both a 3.5% and 4% after-tax real rate of return, the rates assumed in the Kemp-Kasten and Treasury proposals, respectively.

The table shows very clearly that the Treasury's proposed RCRS falls very far short of achieving inter-asset neutrality, even at a discount rate as low as 3.5 percent. The present values of these allowances fall steadily and steeply as the recovery period is increased. Indeed, the present value of the class 7 (or 63-year) cost recovery allowances is only slightly more than half that for the class 1 (5-year) property. In sharp contrast, the present law ACRS with ITC shows a much closer clustering of the present values of cost recovery allowances except for the 18-year property for which no ITC is available. The ACRS allowances afford virtually complete neutrality, when the allowances are discounted at a 3.5 percent rate, the real after-tax rate of return used in the determination of the recovery amounts per year for each asset class in the Kemp-Kasten proposal. Discounting at 4 percent, ACRS (using the same amounts per year for each property class as designated in the case with 3.5 percent discounting) falls a bit farther shy of perfect neutrality, but even so it far more closely approaches this goal than does RCRS. ACRS with ITC conforms quite well, except in the case of 18-year property. Clearly, either NCRS or ACRS with ITC much more nearly satisfies the inter-asset neutrality criterion than RCRS. This is not the result one would have expected given the emphasis Treasury claims to have placed on neutrality.

TABLE I.—PRESENT VALUE OF COST RECOVERY ALLOWANCES PER DOLLAR OF CAPITAL OUTLAY UNDER ACRS [1], RCRS, AND NCRS AT SELECTED REAL AFTER-TAX RATES OF RETURN [2]

Inflation rate:

Recovery class (years)			Present value of allowances real after-tax rate return					
			3.5 percent			4.0 percent		
ACRS	RCRS	NCRS	ACRS	RCRS	NCRS	ACRS	RCRS	NCRS
3	(1)- 5	4	$1.05	$0.92	$0.98	$1.04	$0.91	$0.97
5	(2)- 8	6	1.08	.89	.99	1.07	.87	.97
5	(3)-12	6	1.08	.85	.99	1.07	.83	.97
5	(4)-17	6	1.08	.79	.99	1.07	.77	.97
10	(5)-25	15	1.02	.71	.98	1.01	.68	.95
15	(6)-38	20	.96	.61	.98	.94	.57	.94
18	(7)-63	25	.77	.47	.99	.75	.44	.94

[1] ACRS allowances, except for 18-year property, include the deduction equivalent of ITC, at a 46-percent tax rate.

[2] All allowances are discounted for a ½ in the 1 year, for 1.5 years in the 2nd year, for 2.5 years in the 3rd year, etc.

When inflation is taken into account, the results with regard to inter-asset neutrality are much the same as those found when the inflation rate is assumed to be zero. As Table II–A shows, NCRS, with its indexing, affords the same present value of its allowances for all classes of property when inflation is assumed to be at an annual rate of 5 percent and the real after-tax rate of return is 3.5

With 5 percent inflation and a 4 percent real after-tax rate of return, NCRS results in a small disparity in the present value of its allowances in the case of 15-, 20-, and 25-year recovery property. The same sort of results are found when the inflation rate is assumed to be 10 percent a year, as shown in Table II–B. RCRS, on the other hand, shows the same substantial decreases in the present values of cost recovery allowances as the recovery periods are lengthened that are seen in Table I. ACRS, lacking indexing, fares less well under inflation than with a zero inflation rate in terms of the inter-asset neutrality goal. It remains, nonetheless, superior to RCRS in this respect at a 5 percent inflation rate although inferior to it at the 10 percent inflation rate.[5]

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quent years are then discounted by 1.5 years, 2.5 years, etc. Failure to discount the first year's deduction will overstate the present value of the deductions.

[5] As presented in the Treasury proposal and in the Kemp-Kasten discussion of the FAST, the inflation indexing in both RCRS and NCRS is imperfect. Neither provides for indexing in the first year the asset is placed in service. This implicitly assumes that the inflation rate is always zero in that first year, only beginning in the succeeding year.

TABLE II-A.—PRESENT VALUE OF COST RECOVERY ALLOWANCES PER DOLLAR OF CAPITAL OUTLAY UNDER ACRS, RCRS, AND NCRS, AT SELECTED REAL AFTER-TAX RATES OF RETURN

[Inflation rate: 5 percent]

Recovery class (years)			Present value of allowances real after-tax rate return					
			3.5 percent			4.0 percent		
ACRS	RCRS	NCRS	ACRS	RCRS	NCRS	ACRS	RCRS	NCRS
3	(1)- 5	4	$0.98	$0.90	$0.96	$0.97	$0.88	$0.95
5	(2)- 8	6	.98	.86	.96	.97	.85	.95
5	(3)-12	6	.98	.83	.96	.97	.81	.95
5	(4)-17	6	.98	.77	.96	.97	.75	.95
10	(5)-25	15	.86	.70	.96	.85	.67	.93
15	(6)-38	20	.77	.59	.96	.76	56	.92
18	(7)-63	25	.56	.46	.96	.55	.43	.91

TABLE II-B.—PRESENT VALUE OF COST RECOVERY ALLOWANCES PER DOLLAR OF CAPITAL OUTLAY UNDER ACRS, RCRS, AND NCRS, AT SELECTED REAL AFTER-TAX RATES OF RETURN

[Inflation rate: 10 percent]

Recovery class (years)			Present value of allowances real after-tax rate return					
			3.5 percent			4.0 percent		
ACRS	RCRS	NCRS	ACRS	RCRS	NCRS	ACRS	RCRS	NCRS
3	(1)- 5	4	$0.91	$0.88	$0.94	$0.91	$0.86	$0.93
5	(2)- 8	6	.89	.84	.94	.88	.83	.93
5	(3)-12	6	.89	.81	.94	.88	.80	.93
5	(4)-17	6	.89	.75	.94	.88	.73	.93
10	(5)-25	15	.75	.68	.94	.74	.65	.91
15	(6)-38	20	.65	.58	.94	.63	.54	.90
18	(7)-63	25	.44	.45	.94	.43	.42	.89

In formulating economic policy, one certainly should not assume that inflation has vanished from American economic life and that a return to ten percent-plus inflation is out of the question. Nevertheless, it is ludicrous to devise a system such as RCRS that is superior to current practice only under the assumption of oppressively high rates of inflation. NCRS, in contrast with RCRS, does not rely on this assumption; it much more effectively copes with the twin problems of inflation and neutral treatment among different kinds of capital goods than does either RCRS or ACRS.

NEUTRALITY TOWARD INVESTMENT

The first-level neutrality condition requires that the present value of recovery allowances just equals the capital outlay in the case of every asset. As Table I shows, at a zero rate of inflation the present value of ACRS–ITC allowances discounted at 3.5 percent exceed full cost recovery by up to 8% (in the case of 5-year property), or fall short by up to 23% (in the case of 18-year property). In contrast, NCRS results in almost perfect capital recovery among all asset classes. NCRS fails to reach perfect cost recovery only by virtue of a fault in the discounting methodology used in its construction,[6] a problem that's easily corrected. In sharp contrast, RCRS results in cost recovery that never comes closer than an 8% shortfall and reaches a 53% shortfall for long-lived assets. At a 5 percent inflation rate, the NCRS depreciation schedule falls short of the expensing equivalent by only 4%.

ACRS–ITC is much superior to RCRS with respect to this first-level neutrality condition. Although the value of ACRS deductions are much more severely eroded by inflation than the RCRS allowances, ACRS nonetheless more nearly satisfies this neutrality requirement. Even more astonishing, this is true at an inflation rate of ten percent, except for 18-year ACRS property. Even then, at a 3.5% real after-tax rate of return, ACRS-ITC is inferior to RCRS by only one percentage point.

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[6] The NCRS recovery schedules are designed with the use of a discount function which adds the inflation rate to the real after-tax rate of return to find the total rate of discount, i.e., (1+r+z), where r is the real after-tax rate of return and z is the expected inflation rate. The correct inflation-adjusted discount rate, however, is the product of 1 plus the real after-tax inflation rate and 1 plus the inflation rate, i.e., (1+r)x(1+z).

As shown above, inflation indexing in and of itself does not provide a recovery system superior to the current system. The severe non-neutrality of RCRS, both among assets and as between investment and consumption, cannot be corrected by indexing. And, despite the absence of indexing in ACRS, current law is more nearly neutral, both among assets and with respect to captial in the aggregate, than is RCRS at inflation rates at least as high as ten percent. At more reasonable levels of inflation, around 5%, ACRS is the equivalent of expensing for many asseets.

CONCLUSION

The NCRS holds the promise of achieving important goals of constructive tax reform. In its basic structure, it would make dramatic moves toward full cost recovery without differentiating in this respect among assets with differing recovery periods. With its indexing provisions corrected to account for inflation in the first year in which deductions would be allowed, it would insure achievement of these neutrality goals by preventing erosion of cost recovery allowances by inflation. As a somewhat more extended recovery system than ACRS, it would somewhat reduce the severity of the problems resulting from front-end loading of capital recovery. Because each year's deductions would be smaller in amount per dollar of capital outlay than the ACRS allowances, it would tend to increase the amount of each year's deductions that could be effectively used each year and reduce the amount that would have to be carried over to succeeding years. As an extension of ACRS, it would create far fewer transition problems than would a move toward a substantially different cost recovery system, such as RCRS. Moreover, it would generate additional tax revenue in the early years of its implementation, compared with ACRS-ITC, and thereby make possible desirable revenue-losing tax revisions which might otherwise have to be foregone under the constraints of a revenue-neutral reform program.

There are problems, to be sure, in the design of NCRS. With extended recovery schedules, satisfying the condition that the present values of the allowances for all types of property are the same and just equal to the price of each property depends critically in whether the real after-tax rate of return used in the discount function is appropriate. If the recovery schedules are based on the assumption that the correct rate is 3.5 percent, as in the FAST proposal, the present value of the allowances will exceed 100 percent of the capital expenditure if the actual rate is less than 3.5 percent and fall short of it if the actual rate is greater than 3.5 percent. The extent of the shortfall or excess is not likely to be severe if the rate chosen to determine the write-off schedules is in the neighborhood of prevailing real after-tax rates of return. The statistical record suggests that with a 3.5 percent rate, this is likely to be the case, but it should be recognized that the results with NCRC are likely to diverge from the more nearly optimal ones that would be obtained with true expensing.

NCRS fails to address, but no more than ACRS-ITC or RCRS, the inadequacy of capital recovery systems that gear the beginning of cost recovery to the taxable period in which the property is placed in service rather than to the period in which the costs of acquiring it are first incurred. Although it would somewhat alleviate the problem of wasted deductions, NCRS would not insure that the present value of deductions that must be carried forward would be the same as if they were fully effective in the year in which they are allowed. A similar problem would arise in the indexing provisions in the plan, which, as presently proposed, would not index deductions that have to be carried forward. These deficiencies could be readily overcome by appropriately increasing and indexing the amount of deductions that are carried forward, although this would, of course, increase the complexity of the system.

The NCRS proposal as it now stands leaves a number of important issues to be dealt with. Notwithstanding, it is an imaginative and innovative measure for moving the income tax in the direction of the neutrality that is needed to prevent the tax from distorting market signals and impairing economic efficiency. The Administration would be well advised to replace the retrogressive RCRS with the highly promising NCRS as a major step toward true expensing.

Carlos E. Bonilla, research associate.

Dr. Goode. Mr. Chairman, may I comment on this? I think that most of those who have studied this question don't reach quite the same conclusion as Dr. Ture. There is very good evidence that the present combination of ACRS and ITC results in highly unequal tax rates for different kinds of equipment, structures, and inventories and, therefore, in highly unequal tax rates across industries. And on the average, on plausible assumptions, the result is a negative tax rate, that is, a subsidy for a large part of investment in equipment. I think the argument is—certainly from my point of view—not that we should never use the tax system to encourage investment or some other activity, but that the present system is a very inefficient and unequal way of doing that. And the other point, of course, about international competition is that the real problem is the overvaluation of the dollar and not any defects——

Senator Bentsen. I am not arguing this as being the only thing that causes that obviously. All of us know that the dollar throws us very much at a disadvantage, and we can go through a whole list of other things, whether we are talking about management-labor cooperation or a whole other list of it.

Dr. Feldstein. May I come back, Senator, to your point about the competition? We don't compete with foreigners in the provision of office building services. We do in the kind of things that are made by machines. And I think that is an important consideration in this. Right now, our tax system is effectively neutral with respect to equipment investment. The value of the ITC plus the depreciation offsets the corporate income tax. With respect to structures, we have a heavier tax. There is an unequal burden. The question is whether that is a good or a bad thing in a situation where we are competing with foreigners in the products made by equipment but not in the services produced by buildings. It is not perfect. Obviously, a piece of equipment is inside a plant, but I think in a rough and ready way what the tax law is doing is recognizing the fact that some markets are more sensitive to international competition than others.

Senator Bradley. Could I follow on that, Lloyd? We had a panel last week of executives who said quite clearly that the trade deficits and international competitiveness were primarily functions of other things than the Tax Code. And they said if they had a choice of trying to subsidize a particular industry, they would prefer that the subsidy be direct as opposed to through the Tax Code. Now, what is your comment on that?

Dr. Feldstein. I just worry about the word "subsidy." That is what I was saying in a roundabout way when I first answered Senator Bentsen's question. We are not talking about subsidies. We are all in the tax side of zero here. It is a question of which one——

The Chairman. It is a question of what?

Dr. Feldstein. The tax side of zero. It is a question of whether you have high taxes or higher taxes. Nothing is being subsidized. What we have is a situation where we have in effect neutralized taxes on equipment and still have substantial positive taxes on structures. I don't want to see the Government come into the business of actually writing checks to different corporations.

The Chairman. That is what they meant, I think, though, Bill. That is what they were talking about.

Senator Bradley. They said they felt that was more efficient.

Dr. Goode. Mr. Chairman, the Treasury studies do indicate—Professor Feldstein must disagree with them—that on assumptions of inflation rates of 0 to 5 percent or a little more, there is a negative effective rate of tax on most equipment. That is a subsidy at the present time.

Dr. Feldstein. That calculation, Dick, assumes that corporations can borrow at 9 percent. They have a 4-percent real interest rate, and a 5-percent inflation rate. As far as I know, corporations are paying real interest rates which are more like 7 percent or 8 percent than 5 percent for their long-term—4 percent for their long-term financing. So, I think if you did that with realistic market interest rates, you would find that there was a small positive tax.

Dr. Ture. The deficiencies in the Treasury calculations, Marty, go vastly beyond that. It is because they improperly defined what the effective tax rate is, and with an improper definition, they have worked all sorts of mischief for a long time past. It seems to me the only really relevant concept of effective tax rate is the percentage difference between the present value of the gross returns an asset has to earn with a tax and the present value of required gross returns, if there are no taxes, to warrant investment in the asset.

The Chairman. Senator Heinz, you were next on the list. Why don't you go ahead? We can jump in any time we want, but it is your turn.

Senator Heinz. Mr. Chairman. I am delighted to jump into the middle of things here. Thank you. I would like to ask Dr. Minarik and Dr. Goode, in terms of the $25 billion increase on corporations, what impact do you think these changes are going to have on U.S. companies' ability to compete with our trading partners? And as you look at the tax systems abroad in EC and Japan, what do you see and how would the President's proposal advantage or disadvantage us?

Dr. Minarik. Senator, I think you are tying into some of the questions that have been raised in the last few minutes. I think the nutshell answer to your question is that this tax system or any other like it will have a positive long run effect on our ability to compete, and I think it has a lot to do with how we use our capital.

Senator Heinz. That may be, but I am asking a slightly different question. I am asking how it is going to affect the companies which are principally manufacturing companies, that are either import-sensitive or that have to export, as opposed to whether or not capital will be used more efficiently by a service-based economy, for example?

Dr. Minarik. No, Senator. I think the questions are interrelated. There is a question as to how our firms in tradable goods markets are going to be operating. The situation, as I pointed out in my presentation, the $25 billion tax increase—again, if you look at it by the provisions that are involved—it comes to something much closer to a net wash in terms of general provisions that are not relating to specific industry. And for the most part, our tradable goods industries are not involved there. Where the tradable goods industries are involved in the net tax increase, I think it mostly shows up in the recapture provision, and that is another question that you are going to have to deal with.

Senator **Heinz**. Do you fellows support the recapture provision? Do you and Dr. Goode?

Dr. **Minarik**. I don't particularly like it. There is a question of how one gets from here to there. It is explicitly a transitional issue. The windfall provision is a bridge between a tax system which is front loaded and going to a new back-loaded tax system where, for a period of time, you lose a certain amount of revenue.

Senator **Heinz**. Why don't you like the windfall provision?

Dr. **Minarik**. I think, for the most part, it does seem to be quite selective. The situation with firms with tangible capital is one instance of a windfall, in this transition from one tax system to another. There are other windfalls. I might add, there are other windfalls that are both positive and negative. The administration chose to deal with this windfall. It did not choose to deal with other windfalls.

Senator **Heinz**. Could you submit a list to us of the other windfalls for the record?

Dr. **Minarik**. It could be a very long list.

Senator **Heinz**. Fine.

Dr. **Minarik**. Do you want to deal with my IRA when I take it out of my savings account when I retire next year?

Senator **Heinz**. You will get a tax at a lower tax rate, correct?

Dr. **Minarik**. That is right. So, presumably, I should have a windfall tax. Corporations that are carrying operating losses forward are going to have to pay higher taxes. Presumably, they should get a windfall subsidy. It is not a neat provision.

[The prepared list of windfalls follows:]

THE URBAN INSTITUTE

2100 M STREET, NW / WASHINGTON, DC 20037 / (202) 833-7200

July 1, 1985

Senator John Heinz
277 Russell Senate Office Building
Washington, D.C. 20510

Dear Senator Heinz:

This letter is in response to your inquiry during the Finance Committee hearing of June 18, 1985, concerning windfalls that would arise during the transition from the current tax law to the administration's proposed system.

I could not pretend to present a complete listing of windfalls in such a transition. In general, windfalls would arise in every instance in which recognition of income has been postponed (or accelerated) by the current tax law, because the income would be subject to tax at different (presumably lower) rates in the future. Further, windfalls would arise, for the same reason, where existing long-term contracts will determine amounts of income or deductions in future years. Finally and most obviously, windfalls would occur wherever a specific legal provision affecting contractually determined future income or deductions would be changed (e.g., repeal of a deduction or exclusion). A complete compilation of the legal provisions giving rise to such postponements or accelerations would be an enormous legal project; and needless to say, there are millions of long-term contracts with important tax consequences.

The list that follows is a partial attempt at only the first type of windfall, referring only to officially recognized tax expenditures. This list indicates only that statutory rate reductions might give taxpayers who benefit from these tax expenditures a windfall bonus. Some of these tax expenditures are suggested for repeal in some tax reform plans, however, and so the ultimate status of their users would also depend on any such repeal and the transition rules with which it would be enforced. Further, some of these tax expenditures generally result in perpetual postponement of realization of income under the current law, and so actual receipt of the windfall requires that the postponement of realization would end at some future date. Such windfalls could arise from:

Domestic International Sales Corporations (DISCs) or Foreign Sales Corporations (FSCs);
Deferral of income of controlled foreign corporations;
Expensing of research and development (R&D) expenditures;
Expensing of intangible drilling costs (IDCs) for fuel and nonfuel minerals;
Seven-year amortization of reforestation expenditures;
Expensing of certain agricultural outlays;
Reinvestment of dividends in stock of public utilities;
Exclusion of interest on life insurance savings;

Excess bad debt reserves;
Deferral of capital gains on home sales;
Accelerated depreciation;
Amortization of business start-up costs;
Deferral of tax on shipping companies;
Five-year amortization for housing rehabilitation;
Individual retirement plans;
Exclusion of pension contributions and earnings; and
Deferral of interest on savings bonds.

As was mentioned earlier, this list based on tax expenditures does not exhaust all possible windfalls. One acceleration of realization of income, in effect a negative windfall, would be the carrying forward of net operating losses through the transition. Such losses would have less value after tax rates were reduced. Simple mortgage interest outlays contractually determined under the current law would also have a lower value than was originally contemplated. The exclusion of capital gains on home sales would impose a similar negative windfall.

On the other hand, installment sales would postpone realization of income until the lower tax rates take effect, and thereby would afford a windfall gain.

I hope that this information is useful.

Sincerely,

Joseph J. Minarik
Senior Research Associate

Senator HEINZ. I don't want to cut you off, but let me hear Dr. Goode on that subject.

Dr. GOODE. Yes. May I try to respond to the two main questions?

Senator HEINZ. We ended up with two questions, one on international competition and one on windfalls.

Dr. GOODE. The one on international competition—it seems to me, that we are best served in international competition by having our investment allocation as efficient as possible. I think our international competitive position is dominated by macroeconomic considerations having to do with the budget deficit, monetary policy, and so on, and not by the particular provisions of the tax system. As regards the recapture of accelerated depreciation allowances, I think I share some discontent with that that I sense the other members of the panel feel. The provision was not in the Treasury's original proposals. It is pretty clear they put it in at the last moment in order to obtain some revenue. But having said that, I will go on to say that I differ from Martin Feldstein and believe that an argument of principle can be made for it. Accelerated depreciation is normally looked at as an interest-free loan from the Government. You get to deduct more than economic depreciation today and can deduct less later. This produces a tax reduction followed by a tax increase. If the corporate tax rate is reduced during the later repayment period, it is clear that you do have a windfall gain.

Senator HEINZ. My time has expired. Just a specific point. The amount of the windfall—and I forget what it is—was it $25 billion?

Dr. TURE. It is $57 billion.

Senator HEINZ. How much is it?

Dr. TURE. $57 billion.

Senator HEINZ. Oh, $57 billion. This may be a yes or no answer if you were to do a calculation that really took into account the time value of money, the depreciation schedules, and the difference between the real effective tax rates of corporations before and after the tax bill, as opposed to the theory that they are all going to be paying 33 percent versus 46 percent—if you use real numbers, would the number come out above or below or at $57 billion? My sense is it will go a lot below the $57 billion over the time we are talking about.

Dr. MINARIK. My understanding of what the Treasury tried to do was to recapture, I think, about one-third of what they estimated the windfall to be.

Senator HEINZ. Treasury always uses odd assumptions. I guess my time has expired, but maybe someone can put in a thought or two on that.

The CHAIRMAN. Senator Wallop.

Senator WALLOP. The odd assumption here is the amount that they calculated that they needed to make up. [Laughter.]

It had nothing to do with any windfall or any other thing. I mean, it is really a cynical gesture, I think. I was concerned, Dr. Goode, with one of the statements in your presentation that we should raise the corporate tax not only to what is proposed but even more for symbolism. It would strike me that that symbolism is that the public thinks it ought to be higher. Rather than shoulder the obligation of trying to portray a real picture, we will just accede to whatever it is that the most recent polls have to say. But the idea that corporate taxes as a percent of GNP are down is a reflection of corporate income as a percent of GNP over the last 20 years, is it not? I mean, it is roughly half now what it was 20 years ago—in fact, slightly less than half. It strikes me that logic leads us to the assumption that necessarily whatever the tax is, unless it had been raised extraordinarily, we would have as a percentage of revenue a steep decline as the corporate income—So, what you suggest—isn't it antigrowth and anticapital producing?

Dr. GOODE. I don't suggest, Senator, that we should replicate the percentages that existed at any particular time in the past, and it is certainly true that on some calculations the corporate profit share of the GNP has fallen. But I think Dr. Minarik has some statistics which indicate that the reduction in corporate income tax payments is greater than could be accounted for by any reduction in the corporate profit share. And it stands to reason that is so because of the ACRS and ITC provisions that were adopted.

Senator WALLOP. Let me just suggest that the table I am looking at shows total corporate taxes, not just income taxes, as opposed to 1960. They were 51 percent for corporate taxes as a percentage of corporate income. 1984, total corporate taxes as a percentage of corporate income is 50 percent. So, this is a 1 percent change in 20 years, as their total obligation.

The CHAIRMAN. As a percent of what, Malcolm?

Senator WALLOP. As a percentage of corporate income—total tax.

The CHAIRMAN. Right.

Senator WALLOP. It was 51 percent in 1960 and is 50 percent in 1984. It rose to a high of 59 percent in 1970.

The CHAIRMAN. You mean gross income?

Senator WALLOP. Yes. Total taxes as a percentage of——

The CHAIRMAN. Gross income.

Senator WALLOP. And by the same token, individuals in that same period are roughly paying exactly the same—10 percent individual income taxes and 10 percent today.

Dr. MINARIK. I am sorry, Senator. Did you say that is total corporate taxes, not just income taxes?

Senator WALLOP. That is correct.

Dr. MINARIK. What are the other taxes that are included?

Senator WALLOP. I assume unemployment compensation. I assume the variety of other things that are levied upon them.

Dr. MINARIK. OK. I just suggest that there is probably something close to unanimity at this table that including the business share of FICA tax in business taxes probably misstates the ultimate burden of that tax. I think it is most likely that the FICA tax winds up with the workers.

Dr. TURE. That we don't disagree about, but I think what you are really addressing, quite properly, Senator, is how do the measures of the amount of taxes borne under one particular levy—the Federal corporate income tax—relate to the way in which we measure corporate profits for national income and product account purposes? Following the line that you are suggesting, I would point out that there are a great many developments that have occurred in the last few years that will account for changes in these shares. The corporate community that is in operation today is not the corporate community that existed 20 years ago. There have been changes in the location, for example, and substantially more overseas activity. There are changes in the composition of that activity. The point has been made more often than any of us would like to hear it that we have been shifting in terms of employment, at any rate, increasingly to trade, services, and finance where the measures of the shares of GNP originating in corporations differ materially from, say, manufacturing. So, I think there are so many developments and so many factors to take into account that any easy generalization should be viewed with some skepticism. Nevertheless, let me say this. I do believe that changes in the structure of the Federal corporate income tax have reduced its extraction of income from the corporate sector. I personally applaud that and only wish that it had been much more substantial and much more systematic than it, in fact, has been.

Dr. MINARIK. Let me agree with just that last point, Senator. There is an issue of the effect of what we call "tax expenditures" on the corporate tax takeover over the period you are mentioning—roughly the last 20 years—and I tried to look for some figures this morning. My recollection is, if it serves me, that corporate tax expenditures back in the mid-1960's were in the teens, and at that time, the money we collected—in fiscal year 1967, we collected $34 billion of corporate taxes. So, in other words, corporate tax expenditures were roughly half of what we collected. For the most recent actual year, fiscal year 1984, we collected $56.9 billion, and the measure of corporate tax expenditures was $75 billion. So, in other words, we went from a ratio of $1 of tax expenditures for $2 of collections to a ratio of $3 of tax expenditures for $2 of collections. And that is part of the cause of the decline in corporate revenues over that period of time.

Senator WALLOP. Mr. Chairman, I would just like to make an observation at this moment in time. One of the things that concerns me about the argument of Dr. Cooke and Dr. Minarik is that it ignores the fact that one of the reasons we haven't had an increase in inflation in the last little while, while everybody was predicting it, is because we have, in fact, increased plant capacity substantially over the last 4 years. So, while the percentage of plant capacity in use has actually declined a little bit, the percentage is of a much greater capacity. And part of that is because of ACRS and ITC.

The CHAIRMAN. Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman. Gentlemen, I am as concerned as anyone here about our competitive position, and I have a question to ask you—not because I want to make the point in a rhetorical sense—but I would just like some information. As I look at the level of corporate tax in the United States compared with individual income tax and compare that with one of our major competitors, Japan, this is what I see. I see that if you look at total U.S. taxes, that is, State and local and Federal, property, sales, corporate, individual, et cetera, the total revenue collected by the United States compared with the total revenue collected by the country of Japan, they are proportionately equal in every category I mentioned—that is, sales taxes, property taxes, Social Security. The big differences are on corporate and individual tax. The country of Japan has a much higher corporate tax take as a percent of their total revenue compared to the individual tax than does the United States. The United States has a much lower corporate tax take compared to the individual. But in every other category—Social Security, payroll taxes, property taxes, sales taxes, et cetera—they are about the same, or maybe a point or so difference. Now, we are worried about our competitive position. Some would suggest that we in America should lower our corporate taxes, or at least not increase our corporate taxes, whereas Japan seems to be doing pretty well in a lot of areas and has a different kind of philosophy, it seems. What explains that?

Dr. **Feldstein**. I don't pretend to give you a full explanation. I suspect that one of the big differences is the rate of interest in the United States and in Japan. With interest as a deductible expense in calculating taxable profits and therefore corporate tax liabilities, the high interest rates and the rise in interest rates here has been the single most important factor—shrinking corporate tax liabilities over the last several decades. Japan, as you know, has much, much lower interest rates than we do. I think there is a problem in comparing corporate taxes—it goes back to something that Norman Ture said and that I think probably all of us at the panel would agree about—and that is that you really want to combine the corporation with its creditors and its shareholders and talk about the tax burden on corporate capital regardless of whether it is collected at the corporate level or collected from those who provide the capital as individuals. I don't know the figures for Japan. I suspect if we could compare those, we would see a much lower effective tax rate on capital income in Japan than in the United States. I know that they have very substantial tax-free savings provisions. They have much more favorable tax treatment of capital gains and so on. In the United States the effective tax rate on corporations and their shareholders and their creditors went up very substantially between the mid-1960's and the passage of ACRS. And it has come back somewhat since then.

Dr. **Ture**. Senator, may I add to this?

Senator **Baucus**. Sure.

Dr. **Ture**. I have to express some uneasiness about the international comparisons. Tax laws are seldom what they seem, as we here in the United States certainly know, and trying to make comparisons between the tax structure of Japan and that of the United States and infer therefrom something about relative burdens and competitiveness I think is an extremely difficult thing to do. It also overlooks a major difference between our two economies, and without that difference carefully taken into account, the comparison is even less useful, it seems to me. That difference is between the capital: labor ratio in Japan and here. The higher the capital-labor ratio, the higher is the cost of capital. We have the highest capital-labor ratio in the world, which means that we have got to run much, much faster to stay put. The Japanese, by virtue of their marvelous economic progress since 1950, are catching up with us. They are not there yet, and it has been carefully noted by a number of investigators that their cost of capital—not really because of the differences in interest rates that Marty suggested, but for a lot of other reasons—their cost of capital is much lower than ours.

Dr. MINARIK. Could I add just one thing there, Senator?

Senator BAUCUS. Sure.

Dr. MINARIK. Another point to echo Dr. Ture's statement that tax systems are seldom what they seem, and Dr. Feldstein's point about interest rates. Keep in mind that the interest rates the Japanese corporations pay are not the only interest rates that are held down. They also hold down the interest rates that individual savers receive. And if you want to consider the government regulation of interest rates and holding down the interest rates to savers as being a kind of a tax, and if you somehow account for that in comparisons in the individual and corporate balance, you probably would come up with a slightly different picture in terms of where the burden of government policy is.

Dr. GOODE. May I add a quick comment? I agree that it is very hazardous to make comparisons internationally of the tax systems. I have tried to do that for many years without great success. And I think we find often that those countries that seem to have the most favorable tax systems don't have the best economic performance. There are many factors that enter into international competitiveness and economic performance, in addition to the tax system.

The CHAIRMAN. Senator Chafee?

Senator CHAFEE. I am going to ask a question of each member of the panel, and if you could give me a brief answer, I would appreciate it. As you have ascertained from listening to the questions here asked from this podium, we have a deep concern about those of our products that are sensitive to international competition. It isn't the retailers. It isn't the realtors. I am worried about those of our products that are sensitive to international competition—whether it is building steel or machine tools or computers, whatever it is. Now, let us assume that we are doing all we can to bring down the value of the dollar. We could do more, I agree with you—but let's assume that that is not involved with this question. I don't want an answer that says bring down the value of the dollar. Let's look at the next 10-year period—not next year, not forever, but just the next 10-year period. My question, starting with you, Dr. Feldstein, is: Should we vote for this bill which eliminates the ITC and changes the ACRS and has a recapture provision, or should we attempt to change those provisions to include the ITC and the ACRS?

Dr. FELDSTEIN. That is easy. I think you should try to change it, and I emphasize that in several parts of the written statement.

Senator CHAFEE. Because in those sensitive areas, it is going to be harmful to our competitive position?

Dr. FELDSTEIN. It is, and it will be harmful more generally to our ability to generate economic growth.

The CHAIRMAN. John, I want to be sure I understand your question. Was it: Should we adopt it as more or less it has been given to us, or sort of keep it the way it is? I didn't quite understand what you were asking.

Senator CHAFEE. That is right. The bill that has been given to us eliminates the ITC, monkeys around with the ACRS should we reverse those and attempt to keep the ITC, for example, and make a depreciation schedule that is more akin to the ACRS?

Dr. FELDSTEIN. I would say yes. I would say that the key test is: Have you maintained for reasonable assumptions about the same cost of capital in the United States. Have you maintained the value of the depreciation allowances with ITC? So, you don't have to keep the ITC per se if you adjust the depreciation schedules, but some combination of those should maintain current investment incentives.

Senator CHAFEE. Dr. Ture.

Dr. TURE. Absolutely. I agree wholeheartedly with Dr. Feldstein.

Senator CHAFEE. Dr. Minarik.

Dr. MINARIK. I would lean the other way. I think if the question is an up or down vote on this bill, as opposed to something that looks more like ACRS, you should vote yes on the administration's proposal.

Senator CHAFEE. Yes on the bill because you believe that our competitive industries will do better under that, with the rates cut, than returning to something like the ITC or a faster depreciation?

Senator HEINZ. Mr. Chairman, I didn't get Dr. Feldstein's or Dr. Ture's answer on that question, which is yes or no on the bill in its current form.

Senator CHAFEE. No on the bill in its current form.

Dr. FELDSTEIN. I didn't understand that to be your question, Senator Chafee. That is, you didn't ask up or down on the administration's proposal. As I understood it, you were saying: Do you like the administration's proposal in its current form or should we improve it by changing the depreciation?

Senator CHAFEE. That is right.

Dr. FELDSTEIN. OK. And I tried to answer that by——

Senator CHAFEE. I am not saying the whole bill. I am just talking about these specific provisions. I am not talking about the rest of the bill, just this part, and you would change it around to try and get something akin to the ITC or, if not that, some kind of an accelerated depreciation. You wouldn't. You would leave it alone?

Dr. MINARIK. Is this an essay question, Senator?

Senator CHAFEE. No; it is not. [Laughter.]

It is two thoughts, with four lines to explain it. Dr. Goode?

Dr. GOODE. Senator, I believe that the administration's bill is better than the present system. I think I could propose a scheme that I feel would be better than the administration's bill, but it might be a little presumptuous and it might take more time than you would want me to give to it.

Senator CHAFEE. Well, you have four lines.

Dr. GOODE. I think that the best combination would be a corporate tax rate lower than 46 percent, but higher than 33 percent, combined with economic depreciation and an investment tax credit—a reformed investment tax credit—to give whatever incentive to investment that the Congress believes should be granted.

The CHAIRMAN. Whatever beliefs the Congress should be granted?

Dr. GOODE. Whatever incentive is believed to be necessary, I think, can best be given in the form of an investment tax credit.

The CHAIRMAN. We are asking you that question. [Laughter.]

Senator CHAFEE. You don't ask us a question back. We asked you first. [Laughter.]

Dr. GOODE. My answer as a first approximation is that probably we do not need an investment tax credit with the rate of tax that the administration has proposed. We probably would need an investment tax credit of, say, 5 percent if the corporate tax rate were held higher than 33 percent, somewhere around 40 percent, let us say.

Senator CHAFEE. Under this bill I thought it was 35. Where does the 33 come from?

Dr. GOODE. The proposed rate for corporations is 33 percent.

The CHAIRMAN. And 35 top on individuals.

Senator CHAFEE. Thank you.

The CHAIRMAN. Senator Baucus? No; wait, you already had your turn. Senator Bradley? I apologize. Where did he go? Senator Long, it is your turn.

Senator LONG. I am not going to ask any questions at this time because I didn't have the opportunity to hear the witnesses present their statements. I have been reading the first statement, that of Dr. Feldstein. It is parallel to some of the things he has told us prior to this time. I think it is a rather devastating attack on the retroactive tax that is in this bill.

Dr. FELDSTEIN. It was meant to be.

Senator LONG. If I vote to repeal the investment tax credit as being proposed, that will be the third time that I have voted both to put the investment tax credit on and to take it back off. The previous two times I voted to put it back on because the same President that recommended that I take it off recommended that I put it back on. I recall very well the last time we did it. The results were just what you are predicting in your statement. The repeal of the credit played a major part in putting us into a very deep recession. I recall that I was planning to have a nice vacation with Mrs. Long in August of that year, and President Nixon called us back and frantically urged us to reinstate the investment tax credit. Do you recall what was happening at that time?

Dr. FELDSTEIN. Yes, sir.

Senator LONG. What happened then is about what you are afraid of happening again, I take it?

Dr. FELDSTEIN. Very much so. Very much so, and it seems to me it comes—if enacted in its current form in 1986—at the worst possible time in terms of an economy with a recovery maturing to a point where it can not take that kind of shock and with contractionary first-year effects of deficit reduction. It is a sure-fire recipe for producing a downturn in 1986, which could be avoided.

Senator LONG. I can see by your demeanor, Dr. Ture, that you have an opinion on this. Can you tell us your thoughts on this?

Dr. TURE. I share Dr. Feldstein's concern. I don't think it would be good fiscal policy. I think it would be terrible tax policy. I think what the committee ought to be concerned about is trying to find a capital recovery system—I don't care particularly whether it has an investment tax credit per se in it—but a capital recovery system which provides deductions the present value of which are equal to the price of the asset that you buy. Now, you can structure that—the ingenuities of the members of the committee and its staffs are enormous—and you can structure that any way you want to, provided you meet that criterion. If you use an investment tax credit, so be it. There would be less work for you to do. If you want to give it up, there are any number of other ways of accomplishing the same objective, but that is what you ought to be aiming for—the equivalent of expensing. That is what neutrality calls for.

Senator LONG. Thanks very much.

The CHAIRMAN. Senator Moynihan?

Senator BAUCUS. Mr. Chairman, I wonder if we could follow on and ask the other two witnesses that same question? I think that is an excellent point, that is, if you repeal the ITC——

The CHAIRMAN. And the effect it will have?

Senator BAUCUS. I am just wondering what the response might be if the other gentlemen responded to that same point.

The CHAIRMAN. Go ahead.

Dr. MINARIK. Yes; thank you, Senator. When Professor Feldstein said in his opening statement that he thought that we should hold off on repealing the investment credit in 1986 and then repeal it in 1987, because 1986 was going to be weak but 1987 would be strong, I think he must be doing pushups on his eyebrows. That sounds like a really fine-tuned forecast to me. I guess I would just suggest that if you had $8 billion to spare, that using binding contract rules on the investment credit might do you just about as much good. It would allow investment entered into contractually before the expiration date of the current law to qualify for the investment credit, as an alternative to stretching out the actual postponement date.

Dr. GOODE. I would just say that if the investment tax credit is continued, it is clear that other important changes can't be made without an enormous loss of revenue which we can't afford. So, that is the issue.

Dr. FELDSTEIN. I don't make that proposition based on a detailed forecast of the next 2 years, but you have got to make a judgment, if you decide to change investment incentives, about the timing. You have got to do it on the best guess that you can make about how the economy is going to behave in the next couple of years. I think everything we know about the economy now and about the likely first year impact of deficit reduction tells me that 1986 is going to be a weak year, but the falling interest rates that is going on now, and the fall in the dollar that I hope we will see as a result of all of this in the next, say, 6 months or so ought to, by 1987, with the usual kinds of lags in investment and in exporting, ought to give us a stronger economy in 1987. So, if you have to choose between when to apply this painful medicine to the economy—and I am against it in principle—but if you have to choose when to do it, certainly do it in 1987 when the economy seems stronger.

Dr. TURE. I would fervently hope that you don't have to make that choice. What should guide you should be the concern for a tax system that is as congenial as possible to capital formation.

Dr. FELDSTEIN. As far as the revenue goes, assuming that you wanted to eliminate the ITC and yet you wanted to postpone it for a year—I would postpone the full reduction in the corporate tax for that year. The effects on investment would be very different, and the effects on the pace of the economy would be very different, and yet the distribution of the tax burden would be essentially the same between corporate and individual as under the administration's proposal.

The **Chairman**. Senator Bradley, you were out for just a moment. It was your turn, so go ahead.

Senator **Bradley**. Thank you very much, Mr. Chairman. Dr. Feldstein, in your testimony, you criticize the Treasury II proposal on the grounds that it raised the total amount that corporations pay in tax; it cut the total amount that individuals pay in tax; and it had the recapture provision. So, it is your point of view that a tax reform bill that does not do those three things is preferable to a bill that actually does those three things?

Dr. **Feldstein**. Not quite. Making those changes in this bill would make it a better bill from my point of view. I can certainly imagine other bills that would be worse, even though they didn't do those particular things. That is, if you had any particular bill in mind. [Laughter.]

Senator **Bradley**. Then, the other thing you said in your testimony was the effect of the doubling of the exemption. First, you said doubling the exemption is a $40-billion item, and then you pointed out that 38 percent of the benefit of that exemption goes to families with incomes—over $40,000?

Dr. **Feldstein**. Yes; the top 17 percent of taxpayers.

Senator **Bradley**. So, you suggested that a better way to do it would be to increase the exemption but to deny that increased exemption to incomes above what level?

Dr. **Feldstein**. Senator Bradley, I have a suggestion for you. Think about the proposal you had about moving deductions to the bottom bracket. It is not exactly that, but that is a way of accomplishing the same thing. Allow the $2,000 exemption against the bottom bracket only, or the increase against the bottom bracket only, while preserving the projected $1,080 for people against whatever their brackets might be.

Senator **Bradley**. So, in that way, you would save some revenue and improve the distribution?

Dr. **Feldstein**. Yes; you would save about $20 billion if you don't give the value of the increased exemption to me and to others who will be in the 35 or 25 percent bracket. Just limit that to the job that it is focused on—getting low-income people off the tax rolls and helping to reduce tax burdens on low income families.

Senator **Bradley**. I found it very helpful and interesting. $20 billion?

Dr. **Feldstein**. $20 billion. That is a detailed simulation calculation based on actual tax returns. So, that is the kind of number the Treasury could give you for the same——

Senator **Bradley**. That is amazing. That is almost half of the total recapture.

Dr. **Feldstein**. That is right. Yes; further, you wouldn't need to recapture at all, if you limited the increase in the personal exemption to families with incomes under $30,000.

Senator **Bradley**. Let me ask all of you, at least Dr. Ture: You are basically opposed to the corporate tax. Isn't that correct, and you would like to see a consumption tax?

Dr. **Ture**. Yes, that is right.

Senator **Bradley**. Why do you suppose the President's proposal increased the corporate tax?

Dr. Ture. Well, Treasury I increased it enormously, and Treasury II's increase——

Senator Bradley. From your point of view, that is not the correct direction, is that not right?

Dr. Ture. Yes, I think it is as wrong as it can be.

Senator Bradley. Would you say if even President Reagan proposed an increase in corporate tax then we have got to live with the increase in the corporate tax? And though the argument is made from time to time that it is better not to have one, that is the world in which we live, where we have a corporate tax. The question is: Do you believe that, if we had a more neutral corporate tax, we would improve the overall efficiency of the economy, and would that not help in terms of economic growth?

Dr. Ture. Anything you can do to increase the neutrality with which any tax impacts on the private sector will be a big plus with respect to efficiency. So far as its effect on the rate of economic growth, that is much more problematical. To go to your premise, though, if we have to live with larger corporate income taxes, we ought to recognize that we are going to live not quite so well.

Senator Bradley. Or better—Why in your view is improved efficiency a good thing? Maybe that is the way to deal with this.

Dr. Ture. Because our resources are scarce, and we will get more out of them if they are used more efficiently than if they are used less efficiently.

Senator Bradley. So, any tax reform proposal that improves the efficiency has got to be a net plus?

Dr. Feldstein. But you have to be very careful about what improved efficiency means. I think the Treasury is too simplistic in saying that if we have equal tax rates on all structures and all equipment, somehow that is a more efficient system because what you have to bear in mind is that we have taken as a given in all this that we are not going to tax owner-occupied housing. So, we have got a big distortion in the system to begin with, and given that, it is not appropriate to then be neutral with respect to all other kinds of investments. If we are going to have one big distortion, that is going to have an effect——

The Chairman. But that doesn't count. That is not a business investment. They are talking about trying to be equal among businesses.

Dr. Feldstein. Yes, but it is a very important use of capital in our economy. And so, given that we have distorted capital into owner-occupied housing, what kind of rules do we want to have for business-provided housing, which is a close substitute for it? Do we really want to have very different tax treatment for renters and for owners?

Dr. Ture. But Mr. Chairman, we are looking only at business capital. Our calculations show that under the proposed CCRS system, the effective tax rate on class 6—that is structures—would be over six times as high as the effective tax rate on class 1 property. That is certainly not neutrality, and it can't match efficiency in any meaningful sense of the term.

Senator Bradley. So, is it your position, Dr. Feldstein, that because we allow deductibility of State and local income and property taxes—and I would say many members of this committee and also of the Senate do not want to eliminate those and also want to keep a deduction for mortgage interest—that we have to make other compensating changes? Is that the idea? And how do we determine what changes we make?

Dr. **Feldstein**. Yes is the first part of the answer, and the second part is it is very difficult. And so, I can't give you a formula sitting here, but I can say that you have got to look at where there is close competition. We had a discussion about that before in connection with imports. If we compete in the products of equipment but not in the products of office buildings, then we may want to be more generous in our tax treatment of equipment than of office buildings.

Senator **Bradley**. Is it your position that we should eliminate the mortgage interest deduction and——

Dr. **Feldstein**. I think that that is a closed issue.

Senator **Bradley**. So, that is a political question?

Dr. **Feldstein**. The political issue, I believe, is completely closed, but I think you have to take that as a starting point. If that were not true or if it were not important, then I would say yes—equality means equal effective tax rates on everything. But once you put in that extra wrinkle in the system—and it is a very big wrinkle—then you have to ask that if you are going to subsidize owner-occupied housing, what do you want to do to rental housing that is provided on a business basis?

Senator **Bradley**. But you argued for the elimination of the State and local tax deduction, didn't you?

Dr. **Feldstein**. I did.

The **Chairman**. Senator Moynihan.

Senator **Moynihan**. Thank you, Mr. Chairman. It is wonderful giving all these people their first examinations in years. It may be a useful innovation. Last week, Dr. Feldstein testified before the Ways and Means Committee that this proposal is at best revenue neutral and has a substantial risk of losing revenue. That it would be a fiscal disaster if tax reform became a deficit enlarging tax cut. And further, that an increase in tax revenues is definitely needed to reach the desirable goal of cutting the deficit to 2 percent of the GNP by 1988. Now, in today's testimony, Marty, you have suggested that the investment tax credit be retained. You have suggested that if it is not, it would probably cause a recession in 1986. Something tells me the majority leader is not going to want the recession in 1986. And you have spoken with obvious conviction on the proprieties of the President's proposal to tax retroactively the so-called windfall benefit of rate reduction for excess depreciation. I think the committee panel, without exception, finds this proposal troublesome.

If, as is increasingly probable, we don't take out the ITC, we say we can't tax this depreciation windfall benefit as a matter of propriety, we start fooling around with the ACRS, and we get some more realistic estimates of economic growth over the next five years—if, in sum, it does indeed look like the tax plan is going to be short of revenue—which would be, in your view, a fiscal disaster—should we vote for it?

And let me ask a few more things: How should we come to a responsible judgment on whether it is in fact revenue neutral? Do you think that can be done by the processes by which we write bills? Would you have any prescription for us? Remember, 4 years ago, we produced an ostensibly revenue-neutral measure which produced a permanent $200 billion deficit.

Dr. **Feldstein**. I am glad that you didn't put it so that I could answer yes or no. Let me answer the first part first and say simply, "Be cautious." Obviously, the methods are not precise, and so it seems to me that given the risks of enlarging the budget deficit and the benefits of shrinking it, it would be better to err on the side of caution and to have a margin of safety, a prediction of revenue increase in this bill, so that you can be confident of coming out at least revenue neutral, rather than aiming right at the mark and therefore taking at least a 50 percent chance that you are going to end up with a revenue shortfall. Now, how to finance the specific changes that I said should be financed without enlarging the deficit. As far as postponing the elimination of the ITC, if that were the only issue that could be balanced within the corporate tax collections by postponing the full reduction in the corporate tax. But more generally, I think that there is nothing sacrosanct about 15, 25, and 35. It is nice to have numbers that end in 5, but numbers that end in 7 are not appreciably worse. If the numbers were 17, 27, and 37, that would probably produce about $35 billion a year in additional revenue. The personal exemption, as I indicated, is a very peculiar way to cut taxes for high income individuals. It is not supply side economics. It doesn't lower marginal tax rates.

Senator **Moynihan**. Don't tell that to Dr. Ture.

Dr. **Feldstein**. Dr. Ture can speak for himself. At any rate, reducing the tax burden on higher income individuals ought to be done by lowering tax rates, not by increasing the personal exemption. And as I was saying with Senator Bradley, there is $20 billion in capping the value of the increase in the personal exemption.

Senator **Moynihan**. The question is: If it looks like we are going to lose revenue, should we do it? And at what level ought we satisfy ourselves on this point? We are not good at this obviously. We let a bill go through 4 years ago——

Dr. **Minarik**. Senator, if I may, you want to partition your revenue estimating problems into two parts. One is the problem of forecasting the course of the economy, and clearly, you know, if we have a war in the Middle East, all bets are off. But keep in mind that changes in the course of the economy that are not caused by the change in the tax law are going to affect the old law and the new law equally. If you look at the administration's proposal and look at the big bucks provisions in it, you will see that most of them are provisions that we know a lot about in quantitative terms from the tax returns that we see every year. There is a big change in the personal exemption. We know the personal exemptions. That is a relatively simple thing to do. Repeal of local and State tax deductions is ultimately doable because we know what they are. And on the corporate side, we know what the investment credit is. That is reported every year, although there is a problem with carryforwards which causes you some difficulty in estimating. And then, the change in the corporate rates is relatively easy to work out as well. So, I think that it is easy to exaggerate the difficulty in doing a revenue estimate of this bill on a given set of economic assumption. If you take the assumptions as given, I think it can be done with some——

Senator MOYNIHAN. On the basis of the last 4 years, should we take the Treasury's estimate on something like that?

Dr. MINARIK. I think there are some individual items in there that cause some trouble.

The CHAIRMAN. But also, we have got OMB's estimates. We have got CBO's estimates. We have got the joint committee estimates.

Senator BRADLEY. They are our revenue estimators—the Joint Tax Committee.

The CHAIRMAN. Yes. I am not sure any one is any better than any other, and I am not sure that one more would do us any good, or any harm.

Senator MOYNIHAN. Did we ask the Joint Tax Committee for estimates?

The CHAIRMAN. I don't know. Bill, have we gotten any estimates?

Mr. DIEFENDERFER. Yes, sir.

The CHAIRMAN. Yes.

Mr. DIEFENDERFER. They are doing one now.

Dr. TURE. Mr. Chairman and Senator, can I take a different hack at that? I think that you cannot properly stress the difficulties of these revenue estimates. I don't think it is a question of getting more—possibly even more competent people on your staff to do the estimates. I think they have to be done in an entirely different way. As the Senator on your right observed so many times during the 1970's, the way in which we make revenue estimates conventionally is to assume that nobody does anything, no matter how violent the change in the tax law. And that is an absurdity. It seems to me that one thing you could say with perfect confidence about the revenue estimates we rely on is that they are wrong.

The CHAIRMAN. But which way?

Dr. TURE. Well, some up, some down. [Laughter.]

We don't have any way of knowing that. I would say particularly with respect to those changes in the tax law which are intended to change people's behavior, like changes in our capital recovery provision. You ought to be sure that the static estimates are not correct. Now, the ones that have been proposed in this particular set of proposals, it seems to me, overstate the revenue gain. There will be less capital formation. There will be less revenue flowing from that capital than is assumed implicitly in the Treasury's estimates.

Senator MOYNIHAN. Then you share Dr. Feldstein's apprehension?

Dr. TURE. Oh, I am very much concerned about this. Yes.

Dr. MINARIK. Senator, if I may just add, I don't want to be contentious, but I would just suggest that you think how much better off we would have been after 1981 if we had done the revenue estimates in 1981 on what was a more explicitly static basis. There is a lot to be said for static revenue estimates.

The CHAIRMAN. Yes. We did project there on the assumption of dramatic changes in behavior in investments and returns.

Dr. MINARIK. The economic outlook, one upon which those changes were——

Senator MOYNIHAN. Thank you, Mr. Chairman.

Senator Long. Could I ask a question that would help clear up my thinking on this matter? Dr. Feldstein might know the answer or one of the others here.

I believe it is contended by some that the Federal monetary policy prevented the type of reaction that the supply siders were expecting, namely that the 1981 tax cut was supposed to generate a lot of additional revenue. I think that was the argument made. Is that correct, Dr. Feldstein?

Dr. Feldstein. I don't think you are going to get unanimity on that.

Senator Long. I am not asking whether the tax cut had that effect or not. I am saying that this is the argument that was made.

Dr. Feldstein. We focused on bringing down inflation, and the success in bringing down inflation cost a lot of revenue. The recession that came with that inevitably cost a lot of revenue. So, if the Fed had said let's not worry about inflation—let's just push the economy along the high inflation path it had been on—then I think we would have had more revenue and we would not have faced these deficits when we did. But we couldn't have gone on with an inflation situation that was already in double digits for several years. And so, I think what the Fed did was perfectly appropriate.

Senator Long. Dr. Ture.

Dr. Ture. I have a slight correction for the record, Senator. Fairly early in 1981, I met Dr. Feldstein and one of his associates from the National Bureau in one of the men's rooms at the Treasury Department, and they were there to inform the Secretary about the onset of the recession, which, if memory serves me correctly, Marty, you said was November 1980. My own reckoning of that was that the recession began actually either in the last quarter of 1978 or the first quarter of 1979, as I track what has happened since then. We had bumps up and down in GNP in real terms, but no real movement until the recovery began in 1982. And it was our failure in the Treasury and elsewhere in the Federal executive branch to take full account of the recession forces that were then upon us, which we did not recognize, which led us to make extravagant revenue estimates. But interestingly enough, we overstated revenue loss. We didn't understate it because we measured revenue loss from much higher levels of income than we actually attained.

Dr. Goode. But you reached a different conclusion about the budget deficit, as I recall.

Dr. Ture. Indeed. Had we been able to forecast the strength of the recession forces that we were then experiencing but didn't recognize, I think the whole strategy that we had put to the American public and to the ladies and gentlemen of the Congress would have been different.

The Chairman. I recall when I sat on the Banking Committee—I can't remember who the economist was, but he would come every year and predict what was going to happen for the year. And I had his testimony in one January from the previous year when what he predicted went totally haywire, and I asked him why—could he explain it. He said yes. It was unforeseen intervening circumstances. [Laughter.]

The CHAIRMAN. I said: "Is there anything, doctor, in the ensuing year that could throw off your projections? Oh, no. No unforeseen intervening circumstances. No possibility of that. Well. Senator Symms.

Senator SYMMS. Thank you very much, Mr. Chairman, and I thank all of the witnesses. Dr. Ture, what would your recommendation have been to answer the question. You can make it very brief because I do have a question I want to ask the panel also. Would it have been different?

Dr. TURE. No, I said our strategy would have been.

Senator SYMMS. Oh, your strategy. What would your strategy have been?

Dr. TURE. I think that perhaps we would have taken a much stickier position with respect to ERTA than finally emerged. If my memory serves me correctly, by the time ERTA wound down, we had added a very, very large number of revenue losing provisions, compared to those that were originally proposed. Perhaps we would have changed the timing of the ERTA provisions. We did once. We may very well have done it yet again.

Senator SYMMS. You mean you think the delay didn't hurt the recovery?

Dr. TURE. I think the delay on ACRS hurt the recovery. The delay on the individual tax reduction certainly wasn't pro recovery, but I don't think it was as severely adverse. The cutback in the business tax reductions was much more to the point. I think certainly, on the expenditure side, we would have been much more energetic because we would have had a much higher level of concern about persuading people in the Congress to go with us on spending cuts.

Senator SYMMS. OK. Thank you very much. We are short of time, but I want to frame this question. First I would say that Idaho is a State in which the major income earners are agriculture, timber, and mining. The other large area in our State that has been successful in past years is the recreation business. We have 10 counties in which over 20 percent of the homes are second homes. Resource production and the second home industry provide the livelihoods for many people in my State. I look at this tax bill, and I am beginning to get a little antsy. People may see they are getting a lower tax rate. However, if they get a pink slip and get fired 6 months after this reform passes because Hecla Mining Co., for example, doesn't expand—will the lower-rate matter. So, I have asked accountants and friends of mine in the State to do an analysis of how this bill would affect particular segments of the mining industry. Hecla Mining Co. did an analysis, and I won't go into the details of how they did it, but I think the way they came up with the numbers was very fair; their report gave an unbiased view of what would happen. In the last 5 years, if this law—the President's proposal—were on the books, Hecla would have paid 56 percent higher taxes than they have paid previously. Because of mineral depletion allowances and investment tax credits that they have taken, they are currently maintaining a positive cash flow. They are not making a profit, however, because they sell silver—as the country's largest silver producing company—on an international market. They can't pass the taxes forward to the consumers. They pass them back to production. So, when I look at Hecla, Coeur d'Alene Mines, Asarco, Silver Dollar, etc.—all in the silver business, where many Idahoans get their jobs. I ask why should I support a bill which implies that resource producers will be severely hurt and employment will be curtailed? Dr. Goode, you say we ought to tax corporations more. I will ask each one of you. How do I explain to the guy that loses his job in Wallace, ID that because we taxed the corporations, he is now out of work?

Dr. GOODE. Well, allocating taxes always involves hard choices. I think all you can say is that if we keep provisions that keep down the taxes on the mineral industries or some particular activity, we have to have higher taxes on other activities. We do not see as clearly the harm that does in preventing people from getting jobs in those industries, but we should take that into account.

Dr. MINARIK. I would say that–just to add to that, and I agree with what Dick said–one has to start from taxing any industry on the basis of what should be an accurate measure of income. If you have an industry which has a provision in the Code that allows it to pay tax on less than its income, then that industry will pay lower taxes. Other industries presumably will have to make up the difference, or individual taxpayers. So, the burden has to go somewhere, and presumably, the most reasonable way from an economic standpoint is to measure income first and then tax it in a simple way. One factual issue here is that if the businesses you are talking about now are not profitable, then presumably the effects of changing the tax law are going to be somewhere in the future for them because they are carrying forward losses. And it is only at some point in the future, if they turn around the corner, that they are going to run out of losses sooner and start paying taxes sooner. If they are not profitable now, it shouldn't affect their cash-flow now.

Dr. TURE. It will affect their behavior now.

Senator SYMMS. It will affect the cash-flow on the depletion allowance. See, the price of silver is so cheap right now in terms of cost of production that if you take away depletion from them, then they have to start borrowing money to pay the help. So, that means they will lay the help off.

Dr. MINARIK. So, you are saying that without depletion they would be showing a taxable profit?

Senator SYMMS. Depletion is providing their cash-flow right now. Without depletion, they would have to borrow money to meet the payroll.

Dr. TURE. Senator, I don't think the corporation should pay taxes at all, as I indicated in my opening statement. And I think we ought to be moving toward reducing the burden on corporate entities across the board, rather than increasing them selectively. If the revenue shortfall problem is one that must be dealt with, then I think it would be unrealistic to assume that it needn't be, and there are alternate ways of doing that. My own recommendation would go along with something that has been introduced by a member of this committee. I think we ought to impose something that is equivalent to the value added tax with border adjustments and use the revenue that it would generate to finance the rate reductions and the other positive elements in the President's proposal, without having to resort to the counterproductive base broadeners.

Dr. **Feldstein**. I don't think there is any very good answer to give to those employees. If we were talking about a completely different industry that, for whatever reason, had been given a special tax provision, taking it away would hurt that industry. So, the question is: Is there a long run justification for provisions of this sort? And maybe the thing that you ought to favor is a more gradual phasing out rather than an immediate elimination of this. Ultimately, eliminating this will show up as lower royalty payments for mining rights, lower value of the mining land, in comparison to today's values.

The **Chairman**. Senator Baucus was pursuing a line of questioning a bit ago about Japan and the United States and effective tax rates. I want to pose a question, and tell me if my memory is right. Every year OECD puts out a chart of all of the taxes in all of the principal industrialized and almost half the unindustrialized countries of the world, including all taxes—Federal, State, local, provincial, or whatever the equivalent to our States is and other governments—and that is total taxes. We will get to the incidence in a minute. Of the major industrial countries, only Japan ranks lower in total taxes. All of our other competitors have higher tax rates. Is that agreed? Total?

Dr. **Goode**. Switzerland is about the same, but the statement is essentially correct.

The **Chairman**. Now, I haven't had OECD do it, but I have had the Library of Congress run it. And by the way, one economist said to be careful about Japan. He said they provide a great many social benefits through business that are not counted as taxes that in other industrialized countries are a cost of government. He said it is a cost of business, but it just doesn't show up as a tax. Then, I had the Library of Congress attempt to prepare the incidence of taxation, and here it is a little more difficult, but the Library of Congress study says that, as a rule of thumb, you can say that most of our trading competitors—now, there are variances, but as a rule of thumb—have higher rates of taxes on consumption and lower rates of taxes on capital and income, when you finally add up all the different kinds of taxes they have. I am curious whether you agree with that conclusion.

Dr. **Goode**. They have higher rates of taxes on both, I believe. There may be a difference in the division between capital income and consumption, but it appears to me that most of the major industrial countries just have higher rates of taxes than we do in the United States.

The **Chairman**. They were breaking it down lower, and saying if you add up all the taxes on capital and income, most of them in total have lower taxes on capital and income than we do.

Dr. **Goode**. I haven't done the particular exercise, but I am a little surprised at the result.

Dr. **Minarik**. Senator, if I could just add one thing? I think you get a little bit of information by looking not only at the tax side of the Government ledger, but also at the expenditure side, and you want to keep in mind that the expenditure policies of a number of our international competitors are a lot more propoor if you will than——

The CHAIRMAN. Oh, they have higher rates of expenditures in addition to higher rates of taxation.

Dr. MINARIK. That is right. For many of those countries, in effect, what you are doing with those taxes is you are buying your medical care.

The CHAIRMAN. That is exactly what it looked like to me—that they were levying consumption taxes basically on the middle income taxpayers for the purpose of paying benefits for the middle income taxpayers.

Dr. MINARIK. So, what one might conclude from that is that the net government sector redistributive policies of our competitors are probably not terribly different, but what is different is the extent to which they do things through the public sector that we choose to do privately. So, they have a more redistributive expenditure side of the budget and they pay for that by a less redistributive tax side.

The CHAIRMAN. Dr. Ture?

Dr. TURE. I think in part the problem stems, Mr. Chairman, from how various taxes are interpreted in terms of where they fall. I will give you a single example. A value added tax is always treated as a tax on consumption.

The CHAIRMAN. Yes. Is that fair?

Dr. TURE. I think it is not right. I think the correct interpretation of the value added tax—on the assumption that it is uniformly applied—is that it is in equal proportion to tax on labor and capital income. And if you make that kind of evaluation of various taxes, you might very well come up with different rankings from the ones that you have——

The CHAIRMAN. Run this by me again. You don't count the VAT as a consumption tax?

Dr. TURE. No, I think it, like a universal retail sales tax, is in effect the equivalent of a uniform proportional income tax.

Senator BRADLEY. What?

Dr. TURE. I beg your pardon?

Senator BRADLEY. Could you get into that a little more in depth? Why is it not a——

Dr. TURE. I would like to submit for the record because that is a fairly long statement. As a matter of fact, I have the analysis included in something on value added taxes, but in very summary terms, the way it goes is this. The imposition of a value added tax doesn't increase people's demands for goods and services. But it does impose on the corporations and businesses that pay it an effort to pass those taxes forward, but clearly they cannot do that without reducing the amount of their sales—the physical volume of their sales, unless they are willing to inventory forever and they aren't. Now, if they reduce the physical volume of their sales, they reduce the amount of labor and capital services they employ. And they will probably reduce them in about the same proportions as they use them, and that means that the income flows to those services will go down.

[The prepared information of Dr. Ture follows:]

3

The Burden of a VAT

As noted in Chapter II, the popular view of a VAT is that it is a sales tax—a tax on consumption.

But what's in a name? The important thing is not the particular name which popular or historical usage has given to a tax. The real issue is whether there are some specific implications of this sales tax characterization of the VAT which are important in terms of informing us about how the tax would affect the economy. The conventional way of thinking about this issue goes something like this:

- The VAT is, really, just a multi-stage sales tax.
- A sales tax is not ultimately borne by the seller of the taxed commodity.
- Rather, the seller adds the tax to the price at which the commodity is sold.
- This is true at every production stage.
- The VAT, therefore, must be "passed forward," coming to rest fully at the last transaction, where the last buyer pays the tax in the form of a higher price for the commodity.
- This last buyer, of course, is the "consumer"—the person who ultimately uses the commodities—who has no one to pass the tax forward to.
- The tax, therefore, must be borne by the consumer.

What the phrase "borne by the consumer" means is not at all clear, despite its common use. You would think that it means that a person in his role as a consumer—as opposed to a worker or a saver or investor—is exposed to the tax, presumably reduces the amount of his consumption, and that is the end of the story. That is, the VAT merely reduces real consumption. Let us see whether that is a reasonable conclusion.

Who Pays the VAT?

First, assume that, indeed, every business has "passed the tax forward" by raising the prices of its products by the amount of the tax on the value added at the business' production stage. Then, presumably, *all* prices of *all* consumer products would be higher by the amount of the tax. If the VAT were levied at, say, 10 percent, the prices of all consumer goods and services would be 10 percent higher than if there were no VAT. Of course, none of this price increase would show up as an increase in anyone's dollar income; the 10 percent of the price of all consumer goods and services sold which is collected as a VAT goes to the government.[11] But with the same income and with all consumer goods prices 10 percent higher than if the VAT had not been levied, what do people as consumers do?

At one extreme, suppose they buy the same physical quantities of consumer goods and services. Since they would be paying 10 percent more for the same market basket, they would have less income left over for saving. For example, if without a VAT people generally spent 90 percent of their available incomes for consumption and saved 10 percent, then with a 10 percent VAT and no cut in the amount of things they buy, they would now use 99 percent of their incomes for consumption saving only 1 percent. But if this were the case, in what sense would people have borne the tax as *consumers?* Surely they would have borne the tax as *savers!* And if this were the case, wouldn't it be more appropriate to call the VAT a personal saving tax rather than a sales tax or a consumption tax?

Now look at the opposite extreme in which, with the 10 percent VAT, people continue to spend for consumption the same dollar amount as before. In the example above, where 90 percent of available income is used for consumption in the absence of the tax, this means that people would reduce the physical volume of consumption goods and services they would buy by 9.1 percent.[12] It would certainly seem in this case that the VAT would act like a consumption tax—that people would assume the burden of the VAT in their roles as consumers.

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[11] With a 10 percent price increase, one dollar spent for consumption goods buys what $.909—$.91, rounded off—bought before the VAT and the (assumed) resulting price increase. On the assumption that it is completely "passed forward," the 10 percent VAT reduces real income by 9.09 percent. It is, therefore, the equivalent of a 9.09 percent income tax on all income.

[12] If out of every $100 of available income, people would buy $90 of consumption goods in the absence of the VAT and would continue to spend $90 with a 10 percent VAT, then the physical amount of their purchases would have to fall to what they would have paid $81.82 for before the VAT. Paying 10 percent on top of $81.82, or $8.18, in VAT makes the total amount paid $90.

The story cannot end here, however. If with a 10 percent VAT we were all to buy 9.1 percent less of consumer goods and services than without a VAT, the stores and merchants and other businesses from whom we buy these consumer items would, obviously, sell 9.1 percent less. But if the physical volume of sales at the retail level were cut by 9.1 percent, the firms whose sales are reduced would find that they are carrying too much stock and would seek to cut back on their inventories. They would accordingly decrease their purchases from their suppliers unless their suppliers were willing to reduce their pre-VAT prices, so that retail prices need not be increased by the full amount of the VAT and so that, therefore, physical sales volume wouldn't fall so much.

If the companies supplying goods and services to retail outlets were not willing to absorb the VAT by cutting their pre-VAT prices, then *their* sales to retailers would be reduced, in our example by 9.1 percent. They, too, would reduce their purchases from *their* suppliers unless they could pursuade them to cut *their* prices. And so on, through the production chain to the initial raw material suppliers. In this extreme case, either businesses must cut their prices by the amount of the VAT, so that their prices with the VAT would be the same as they were without it, or they must cut the physical amount of the goods and services they purchase from other firms so that their total outlays would be the same as they were before the VAT was imposed.

When customers reduce their purchases, their suppliers reduce their production. Reductions in output, of course, mean that fewer production inputs—principally labor and capital—are needed. The reduction in the physical volume of retail sales which we have assumed in this extreme case must set in motion a cut in employment of labor and in the amount of capital facilities companies can profitably use, hence a reduction in investment. Of course, they could continue to use the same amount of labor and capital if the price they needed to pay for these inputs were reduced, i.e., *if workers would accept lower wage rates and if investors would accept lower rates of return.* In either event, *total* wages and *total* returns to capital would decrease, in the aggregate by the amount of the VAT collected. Whether workers and investors accept lower rates of remuneration or insist on the same rates and sell less of their production inputs, their aggregate incomes must fall by the amount of the VAT. But then, the VAT would not be borne by people as consumers but as workers and investors!

Neither of these extreme cases is likely to be the actual outcome. Far nore likely is that at the outset prices would be increased by some ubstantial fracton of the VAT for some products and services at some roduction stages and by a very small fraction, if any, for other goods nd services. Initially, there would be a fairly substantial impact of the 'AT on rates of pay and/or employment and on rates of return and/or ıvestment in some kinds of production activity and little impact elsehere. In a practical sense, some companies would face little obstacles, ıitially at any rate, in passing the tax forward to their customers. This ould be true where, for whatever reason, the elasticity of demand for ıeir products is relatively low: that is, where the percentage reduction their sales would be less than the percentage increase in their prod:t prices. But other companies would encounter various checks on eir ability to increase their prices by any substantial fraction of their AT liability without severe loss in sales. This might be the case, for ample, when a competing firm has a much lower VAT liability as a rcent of its overall sales because it has larger deductions for capital tlays, and therefore is inclined to raise its prices little, if at all, seekg to expand its share of the market by restraining its price increases. r a company facing any such limits on raising its prices, the VAT bility must quite directly come out of the returns to the capital it es, the payments for the labor it employs, or both. In time, however, composition of employment and of investment would change, tend to diffuse the effects of the VAT on the amount of production ints and the payments for their use throughout the private sector of the nomy. The ultimate effect of the VAT, then, is likely to be some neral increase in the prices of goods and services produced in and sold the private sector, some reduction in the amount of goods and servs produced for and sold to the private sector, some reductions in the ount of labor and capital services employed in the production of se goods and services, and some reduction in the aggregate ments for these production inputs.

o these kinds of effects describe the consequences of a tax borne by ple as consumers? In a sense, the answer is yes: people would be ing some lesser physical quantity of goods and services in the ate sector markets and paying some more for them. But they would be carrying the burden of the tax as workers, as savers, investors, risk-taking entrepreneurs.

n fact, it is principally as suppliers of production inputs—as workand as savers-investors—that people would bear the burden of a

VAT. Assuming that the government spends the proceeds of the VAT, its imposition would very likely change the composition—not the aggregate amount—of total output; the government's market basket of demands, presumably, differs from that of the average household or business. And people might very well derive less total satisfaction from the resulting mix of public and private goods and services than they would have if the government had not imposed the tax and used the revenues to finance its activities. This would, indeed, be a burden on people as consumers and it might well be a substantial one, but it would stem from the change to a less satisfying mix of consumption—too much of public goods, too little of private ones—rather than from a reduction in the total amount of consumption.

On the other hand, as we have seen, the imposition of the VAT would surely reduce the aggregate rewards for labor and capital services. Even if the imposition of the tax and the spending of its proceeds were not to reduce total production, the government, by virtue of its levying the tax, would claim a larger share of the income generated in the production activity. The amount of the total income available as rewards for those supplying production inputs, therefore, would be less by the amount of the tax.

We are left with the conclusion that irrespective of whether or how much of the burden of the VAT would be borne by people in their role as consumers in the way of reduced real consumption, people would surely bear the full burden of the tax in the form of less real income available to them as rewards for providing production inputs—as workers and savers-investors, i.e., in the form of reduced after-tax wage rates and reduced after-tax rates of return on capital.

This picture of how the VAT would affect people is, of course, quite different from the conventional scenario. Indeed, most business people believe that they fully pass forward any sales or excise taxes they pay and that they would similarly act only as conduits for any VAT that was imposed. Our discussion to this point suffices to suggest that even if a business believes it sheds the tax by raising its prices, it does so only at the cost of reduced sales, hence reduced production, employment, investment, and gross payments for production inputs.

The "consumption" tax characterization is often derived from a somewhat different approach. For the most part, it is assumed that the version of the VAT which would be adopted in the U.S. is the one most widely used—the so-called "consumption" VAT. As we have seen, this kind of VAT is distinguished from the other versions by virtue of the treatment of capital outlays. In this type of VAT, expenditures to acquire production facilities are deducted from the tax base at the time of expenditure, rather than being written off over an extended period by way of depreciation deductions.

From this it is only a simple step to hold that since value added in the production of these facilities is excluded from the VAT (because purchases of these facilities are deductible) and because value added by government would also be excluded, only consumption outlays are left as the base of the tax. Total value added throughout the economy is equal to the gross national product (GNP). GNP consists of the purchases by private households of consumption goods and services, by businesses of capital items—plant, equipment, other production facilities, and by government of a mix of products and services. If the latter two classes of purchases are excluded from the VAT, then clearly the tax must fall solely on consumption. Q.E.D.

As our previous discussion shows, the line of reasoning just outlined really is not informative about the burden of the VAT since it tells us nothing about how people react to the tax. Moreover, identifying the purchase component—consumption—of GNP on which the tax is levied does not identify the income stream out of which all taxes must be paid. All it tells us is that the incomes generated in the production of consumption goods and services are those on which the tax initially falls.

Consumption goods and services, like all goods and services generally, are produced by some combination of labor and capital. Designating consumption purchases as the base of the VAT is, therefore, to impose the tax on the payments of labor and capital services used in the production of consumption goods and services.

The conclusion we should draw from this discussion is that the fact that a tax is imposed at the time of the sale of a product or service—hence the name "sales tax"—doesn't tell us much about who bears the tax or what the true nature of the tax is. Neither, as we have seen, does the claim that the tax is "passed forward" to consumers (i.e., prices are higher) mean much in terms of real effects on consumption or saving and investing. Nor does the national income accounts arithmetic, showing that only the consumption component of GNP is subject to the tax, identify the ultimate burden of the VAT.

One important implication of this conclusion is that the differences among the methods for assessing and collecting the VAT—the addition, substraction, or invoice methods—are not relevant in terms of determining the ultimate burden of the tax. The way in which firms *initially* react to the imposition of the tax might, indeed, be influenced by the assessment method. The invoice method more than the addition or subtraction method might lead temporarily to the conclusion that the tax is completely passed forward and that it should not and does not affect the firm's operating results. But, as we have seen, the firm would soon be disabused of this view. Whether or not it promptly perceived the change in its sales volume and net return attributable to its efforts to pass the tax forward, the results would in time be very much the same as if it were to have recognized at the outset the limits on its ability to shift the tax. By the same token, the results would be just the same as if the firm's tax liability were determined by use of either the addition or subtraction methods. The real effects of the VAT, in short, do not depend on the assessment or collection method.

More instructive in characterizing a tax is to identify its effects on the costs of alternative behavior and courses of action for businesses and individuals in the private sector.

Effects of VAT on Relative Prices

Every tax increases the cost of something to someone in the private sector. An income tax, for example, increases the cost of using your time, energy, skills, and tools to produce income from transactions in the market place compared with that of using the same time and resources in other ways. Suppose, for example, a person were to earn, say, $10 an hour. If there were no income tax, each hour the person could spend on the job but chose to spend, instead, in leisure would cost him or her $10, the amount that could be earned at work. Another way of saying this is that the last hour worked would cost the person $10 worth of foregone leisure, or to obtain $10 of income from work one must forego $10 worth of leisure. If an income tax is imposed and the marginal tax rate the person faces were, for example, 25 percent, giving up an hour's work of effort costs only $7.50 of income, not $10 as before. To get $10 in available income, one would have to give up an hour and twenty minutes of leisure, instead of an hour. At the same time, an additional hour of leisure would cost only $7.50 of foregone income, instead of $10 before the tax was laid on. The income tax, in short, raises the cost of working and reduces the cost of not working.

An income tax, at least one of the sort we have in the United States, also makes it relatively more costly to save and invest than to consume one's income. The cost of using any dollar of your income to buy consumption goods or services today is the amount of tomorrow's purchasing power which you forego by not saving and investing that dollar. By the same token, the cost of getting greater future purchasing power by saving and investing is the amount of current consumption you must forego. An income tax increases the cost of both current consumption and future command over goods and services, but it raises the cost of increasing your future purchasing power more than that of current consumption.

To see this, suppose that there were no income tax and one could use $1,000 of income to buy $1,000 worth of goods now or to buy a bond paying 5 percent or $50 interest for a year; that is, a year from now you would have $1,050. This means that the real cost of $1,000 worth of consumption is foregoing the $50 of income which your investment of $1,000 would produce over the year; and the cost of having that $50 of additional income next year is giving up $1,000 worth of consumption this year. Suppose that in the absence of an income tax, with the amount of income you actually have, you were just on the margin between using your last $1,000 of income for current consumption or for obtaining $50 more income next year. Your cost per dollar of the additional income is $20.

Now suppose an income tax is levied and your marginal income tax rate is 25 percent. After you pay your tax, this last $1,000 of your current income is cut to $750 with which you can buy $750 of consumption goods. With the same interest rate, your last $1,000 of income, after you pay your tax, will get you $37.50 of additional income next year. But, of course, you don't get to keep all of the $37.50 because the tax applies to this additional income too. If your additional income doesn't take you into a higher bracket, the $37.50 is cut by the tax to $28.125. And to have $28.125 more income next year, you have to give up $750 of current consumption. Each dollar of additional income now costs you $26.67 of foregone current consumption, compared with $20 before the tax was imposed. Your 25 percent income tax has increased the cost to you of obtaining additional future income by 33⅓ percent

$$\left(= \frac{\$26.67-\$20.00}{\$20.00} \times 100\right).$$

Another way of seeing this is by noting that with the 25 percent tax you pay you would have to have $1,333 of pre-tax income to be able to get $1,000 of current consumption, but to have $1,050 next year—$50 more of additional *after tax* income—you would have to have $1,777.78 of pre-tax income this year.[13] This is a third more than the $1,333 of pre-tax income you need in order to have $1,000 of current consumption. The 25 percent tax has increased your cost for future income *relative to* your cost of current consumption by 33⅓ percent.

In these two examples, it is readily seen that the tax raises the cost of one thing relative to the cost of an alternative, e.g., it increases the cost of work relative to leisure and of saving relative to consumption. Virtually every tax ever devised has the same sort of effect—that of raising the cost of some thing(s) relative to the cost of other things.

A tax or tax system which had the effect of increasing all costs which the private sector confronts in the same proportion would be truly neutral. It would, for example, raise the cost of leisure percentage-wise the same as it raised the cost of working. It would in equal proportion increase the cost of consumption and saving, of labor and capital services in production, of each type of labor service and each type of capital service, and of each consumption good and service, etc. To repeat, no tax yet devised has been completely neutral in this sense; every tax alters relative costs.

This differential cost effect offers us a guide for characterizing any tax. A tax which, for example, increased the cost of using labor services compared with capital services can be usefully identified as a labor tax. A tax which increased the cost of saving relative to the cost of consumption should be identified as a tax on saving. Following this line of reasoning, if the VAT is appropriately characterized as a consumption tax, we should be able to determine that it increases the cost of consumption relative to the cost of saving. In fact, the so-called consumption VAT increases the cost of consumption in the same proportion as the cost of saving. It is likely, therefore, to reduce consumption in the same proportion as it reduces saving. And unless numerous exceptions or special rates were provided, it would be likely to reduce all kinds of consumption outlays in the same proportions. Similarly, it would raise the cost of labor and capital services in the same proportion.

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[13] On $1777.77 of additional future income your tax would be $444.44, leaving you $1,333.33 which, invested at 5 percent, would give you $66.67 on which the tax would be $16.67, leaving you $50 per year.

VAT Effects on Relative Costs of Consumption and Saving

We can use the same example as above to show that a VAT will increase the cost of consumption and of saving in the same proportions—will not make it relatively more costly to consume than to save.

Returning to the earlier example, with the income you actually have you are just on the margin between using your last $1,000 of income for current consumption or to obtain $50 more income next year, if there is no tax. That is, if it costs you $20 in foregone current consumption to have one additional dollar of income, next year you will want to use $1,000 of your current income to buy a source of additional income.

If a "consumption-type" VAT is laid on, with a rate of, say, 10 percent, your marginal $1,000 of income will, presumably, buy you $909.09 of consumption goods;[14] to be able to buy an additional $1,000 of consumer goods, you will need $1,100—10 percent more income. The VAT raises your cost of consumption by 10 percent. What happens to your cost of saving?

With the consumption type of VAT, you do not have to pay the tax on your purchase of a machine or some other piece of equipment or other production facility that, absent the tax, costs $1,000 and provides $50 a year in income. On the other hand, if you want to use the $50 of income the production facility affords for consumption, it will buy you only $45.45 of real goods and services, since you will have to pay the 10 percent VAT on these purchases. After the VAT, your $50 of income is worth $45.45. If you want $50, you will need to buy more machines or other production facilities and, assuming their productivity does not change as you buy and use more of them, you will need to purchase $1,100.00 of the machines; this will produce $55 of income which, with the 10 percent VAT "passed forward," will buy you $50 of real goods and services. The VAT raises the cost of obtaining the additional income next year by 10 percent. This is just the same percentage increase as the rise in the cost of consumption resulting from the VAT.

A "consumption" VAT increases the cost of consumption and of saving in the same proportions. It does not make consumption relatively more costly than saving. If we identify a tax in terms of its effects on relative costs, the designation "consumption" clearly is a misnomer for the type of VAT which is widely called a tax on consumption.

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[14] This assumes the VAT is fully "passed forward."

VAT Effects on Amount of Consumption and Saving

Now that we have seen that the so-called consumption VAT does not change the cost of consumption relative to the cost of saving but increases both in the same proportion, the question is whether either consumption or saving will be *relatively* more depressed by the tax. Would, for example, a 10 percent VAT reduce consumption proportionately more than it would reduce saving?

The obvious answer is that both would be cut back in the same proportion, although not in the same absolute amount. As we have seen, the tax would increase the cost of saving and of consumption by the same percentage. By the same token, it would reduce in the same proportion the real consumption and the real additional future income obtainable from consuming or saving any given amount of current income. Since saving and consumption add up to total income (in the absence of taxes), the VAT reduces real income in the same proportion as it reduces real consumption or real saving per dollar of current income.[15]

With the same percentage cut in the real current consumption or real future income which a dollar of current income can buy, the VAT exerts no pressure to shift the proportionate use of your income between consumption and saving. It is, therefore, a *neutral* tax in this respect.

To be sure, you are likely to reduce the *absolute* amount of your real consumption more than you cut the absolute amount of your real saving in response to the imposition of a VAT. This, of course, merely reflects the fact that most of us use a far larger proportion of our available income for consumption than for saving, so that equal *percentage* reductions in both would entail much larger *absolute* reductions in our consumption than in our saving.

For example, suppose your current available income is $20,000 and you usually use $18,000 of it for current consumption, saving the remaining $2,000. Now suppose a 10 percent VAT is levied and is "passed forward" in real terms: your $18,000 of consumption outlays will buy you only $16,363.64 of goods and services. If you've been earning 5 percent on your savings, your $100 of interest will be worth only $90.91; it is as if you were saving only $1,818.18 without the VAT, in-

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[15] If t_{VAT} is the VAT rate, the VAT increases the cost per dollar of saving or of consumption, as we have seen, to $1 + t_{VAT}$. It reduces real income by

$$\frac{1}{1 + t_{VAT}}$$

stead of $2,000 with it. Your real income, then, is cut by the 10 percent VAT to $18,181.82, or by $1,818.18. Of this reduction in real income $1,636.36 is the cut in your real consumption and $181.82 is the cut in your real saving. To repeat, while the VAT bears more heavily on consumption *in absolute terms*, it does not burden consumption *relative* to saving.

Is the VAT Regressive?

Our discussion to this point has shown that the VAT imposes equal proportionate burdens on saving and consumption and on the compensation for labor and for capital. In other words, the VAT is to be seen as falling with equal percentage weight on the various uses and sources of income. In this respect, therefore, the "consumption" VAT should be characterized as a proportional income tax.[24] But most people, in characterizing a tax as progressive, proportional, or regressive, do not focus on the kinds of considerations we have explored so far. Instead, they are concerned with whether the tax takes a larger share of income at one income level than at another.

Actually, there is much confusion in the use of the terms "progressive," "proportional," and "regressive," in characterizing a tax. For the most part, such terms are used to describe the ratio of the tax to income at different income levels. But the terms are used with fair frequency in depicting how much of the total amount of the revenue produced by the tax is collected from people at each income level. These two concepts, however, would produce the same results only by coinci-

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[23] Changes in average weekly hours worked reflect changes in the amount of labor services offered *and* in the amount of such services demanded. Taking account of both of these sets of factors, our econometric investigations lead us to conclude that both income and price effects are significant but that the price effects are somewhat more powerful.

[24] This assumes that exemptions and exceptions are held to a minimum.

dence. A tax that is highly progressive in the first sense might be highly regressive in the second, reflecting the distribution of income by income level rather than the character of the tax. This type of result is illustrated in the case of a hypothetical tax in the following table.

			Tax Revenues	
Income Bracket	**Tax Rate**	**Income**	**Amount**	**Percent of Tax**
0-10,000	5%	800,000	40,000	57.1
10,000-20,000	10%	200,000	20,000	28.6
20,000 and over	50%	20,000	10,000	14.3

The question at this point is whether a tax which is proportional in terms of its weight on sources and uses of income is also proportional in the sense of taking the same percentage of income at each income level. In these terms, is the VAT progressive, proportional, or regressive?

The popular view of the "consumption" VAT, levied without significant exemptions or exceptions, is that it would be a highly regressive tax. This view rests on the assumption that the VAT is a tax on consumption; since consumption is thought to take a smaller fraction of one's income the greater one's income, the conclusion is that the VAT, levied at a flat rate on consumption outlays, would take a larger fraction of the income of the poor than of the rich.

It is this widely-held view of the nature of the VAT which principally accounts for the opposition to its adoption as part of the Federal tax system in the United States. And, as already suggested, it is this perception of the tax which leads many of those favoring its adoption, but concerned with its alleged regressivity, to suggest that various exceptions or exemptions from the VAT should be allowed or that compensating adjustments should be made in other taxes. As noted earlier, a frequent suggestion is to exclude from the VAT various classes of output such as food, clothing, shelter, and health care. Noting the potential complexities and impairment of neutrality—one of the VAT's principal advantages—in this approach, an alternative that is seriously considered is to provide some sort of individual income tax offset for low-income individuals, perhaps in the form of an income tax credit which decreases as the amount of taxable income rises.

As our earlier discussion has shown, the view of the VAT as a consumption tax is, at best, only partially correct. Moreover, the extent to which it is correct at all does not derive from consumers' appearing to "pay" the final tax. Although sometimes ignored in the heat of debate, one fact on which tax experts are generally agreed is that he who pays a tax is not necessarily he who bears its burden. We have seen that people are likely to reduce their consumption *and* their saving in equal proportions in response to the VAT, thus shifting the burden of the tax "back" to producers—to those supplying production inputs. The VAT may appropriately be seen as burdening consumption insofar as revenues are used to finance government activities the products of which afford less satisfaction than those which would have been consumed in the absence of the tax. But in this sense, there is no way of telling whether the VAT burdens consumption more or less than any other tax producing the same amount of tax revenues. Nor is there any *a priori* basis for determining whether this sort of consumption burden is heavier on the poor than on the affluent.

If the characterization of the VAT as regressive depends on its solely or unduly burdening consumption, then the VAT is not a regressive tax. To warrant our describing it as regressive, we would have to find that the VAT weighed more heavily on low-income than on upper-income individuals as suppliers of production services. This finding, in turn, would depend on our determining that the VAT entailed a change in the composition of output from goods and services produced by low paid workers and with capital provided by low-income savers to products employing more highly rewarded workers and savers. This shift in output would more severely depress the earnings of the former than the latter.

Any such change in output composition as a source of a regressive burden of the VAT would not be inherent in the tax. It would result, instead, from exemptions, exceptions, or preferential rates which, presumably inadvertently, favored highly-rewarded over less well-rewarded producers.

This is, of course, quite a different view of the possible regressiveness of a VAT from the conventional idea. It argues for minimizing exceptions, rather than, as in the conventional approach, for exempting those classes of output deemed to be necessities and consumed as a disproportionately large share of the income of the poor.

Senator **Bradley**. We had people in here last week, and we asked the same question about the value added tax, and they said they didn't see a decrease in sales.

The **Chairman**. But they opposed it because it was a regressive tax.

Senator **Bradley**. Right.

The **Chairman**. And these were the presidents of some of our major corporations. That is interesting.

Dr. **Goode**. It would be wrong to assume that there is unanimity in the panel on Norman Ture's interpretation.

The **Chairman**. That is why we have the panel here. Marty.

Dr. **Feldstein**. I think it is a consumption tax. I think, though, there is a question of how you want to look at people's tax payments. After all, each of us is a consumer and he is also an earner. So, it depends on which side of the account ledger you look at. Norman is saying if you look at us as earners of labor income and earners of capital income, then that exhausts all the income we have. So, obviously, the tax comes out of labor income and capital income, and the only question is in what proportions. You can flip it over and say: But on our spending side, it is a tax on what we do with that money. But it is clearly different from a general income tax in that it exempts savings. So, it is a tax on consumption. It exempts savings. Assuming that the VAT is a tax on consumption goods, that is, that it exempts in the calculation of the value added tax equipment and other kinds of investment goods. That is what tax specialists call a consumption style VAT. That is a tax on consumption, but ultimately, it gets borne by people as earners of labor income and capital income. I would say most economists would say that a pure consumption tax is equivalent to a tax on labor income, not equivalent to an equally split tax, as Dr. Ture suggests.

The **Chairman**. Senator Baucus.

Senator **Baucus**. I would like to follow this up a little further. Why not use a VAT of some kind to make up for lost revenue here, rather than the windfall tax as proposed in this bill?

Dr. **Feldstein**. Well, the windfall tax is a 4-year tax.

Senator **Baucus**. I beg your pardon?

Dr. **Feldstein**. The windfall tax is a 4-year tax, so you are not going to put a VAT in place for 4 years. So, if you want a VAT, it has to be substituted for some permanent feature or to reduce budget deficits, but I don't think that it is a starter for a temporary tax.

Senator **Baucus**. Some suggest that in the long haul it would make more sense for the United States to move a little bit away from a corporate income tax and more toward a kind of value added tax, maybe with some kind of progressivity that can be built into it. It helps our trading position. It is more efficient, et cetera. I would like each of you to respond to that, please. Phase out over a period of time the corporate income tax. Phase in a VAT. One argument is that other countries have VAT's or something like VAT's, so there would be more similarity in the tax systems. A second is that it is more efficient. A third is it tends to encourage savings, rather than consumption, which a lot of people think we need to work toward. I would like your reactions to that.

Dr. **Ture**. I think if the taxwriting committees and the Congress can bite the bullet, the decision to go to a value added tax—irrespective of what name you call it——

The **Chairman**. Irrespective of what?

Dr. **Ture**. What name you call it—will give you a flexibility—an expansion of tax policy opportunities that would be just tremendous. In the current context, for example, if one went along the lines that I have suggested, you could use a substantial fraction of the revenues that that tax would generate to, say, reduce part of FICA. You could use some of it to obviate the need for disallowing the deduction for State and local taxes. You could certainly use a part of it to do away entirely with this proposed recapture. And there are any number of other things you could do. I am suggesting that the introduction——

Senator **Baucus**. You would favor moving in that direction?

Dr. **Ture**. Oh, yes, indeed.

Senator **Baucus**. Dr. Feldstein.

Dr. **Feldstein**. I have a variety of problems with the value added tax. At one level, I find it very attractive, but—and it certainly is, as you said, a way of reducing the current disincentives against savings. I think the distributional problems are serious. I think that to continue in effect to exempt families up to—as proposed in the current bill—$12,000 of income for a family of four with a value added tax would require making cash payments to them of as much as $1,000 or $1,200 to offset the value added tax payments that they had made. That means a cash transfer welfare system for the United States of a form that we just don't have now in the Federal Government. I think there are a lot of problems with that. There are a lot of compliance problems with the Treasury sending out checks to what might be as many as 30 or 40 million households.

Senator **Baucus**. What do other countries do? Do they pay checks——

Dr. **Feldstein**. In other countries, they frequently do not have any offsetting provision. They simply have a proportional value added tax. If you go to Sweden, they say, yes, we have a value added tax, but of course, we provide housing benefits, health care benefits, and a variety of other things which are designed to help low-income families, and we think it will all wash out. But I don't think we are going to radically transform what the Government spends money on here—I hope we are not—in this process.

Senator **Baucus**. Would you respond to Dr. Feldstein's point, Dr. Ture?

Dr. **Ture**. I am not really concerned about these so-called administrative problems that come up in the effort to even out the distribution of tax liabilities, when you introduce an entirely new tax. The introduction of that tax doesn't necessarily mean that the individual income tax vanishes from the face of the Earth, and we can use the individual income tax with various provisions in it—personal exemptions on a vanishing basis, to be sure—to offset anything that people perceive as a regressive impact of value added taxes.

Dr. **Feldstein**. But only if you are prepared to have a rebatable credit. Only if you are prepared to send checks.

Dr. **Turk**. We send out millions of Social Security checks every month.

Dr. **Feldstein**. To people who have built up a long record. Here you have got more Mr. and Mrs. Jones sending in a letter saying I make $11,000, and I don't have to file an income tax return. Please send me my check.

Senator **Bradley**. So, this makes George McGovern's demogrant pale in comparison?

Dr. **Feldstein**. It is the Reagan demogrant in its way.

Dr. **Minarik**. And keep in mind, Senator, that when Mr. and Mrs. Jones send in their letter—as Dr. Feldstein suggested—you are talking about $1,000 and $1,200 for a family of modest income. That money they paid all year and then they are waiting for their check toward the end of the year. It is not the best cash-flow system if you are going to do it on an annual basis for low-income people. If you decide you want to rebate to them monthly or quarterly, then you have got the Internal Revenue Service into the business that we now have from HHS.

The **Chairman**. How does it differ from the earned income credit now, or in essence, in terms of the rebate?

Dr. **Feldstein**. You have got to have earnings, and on this you would not.

The **Chairman**. Most people do have earnings, and you have got that kind of a record.

Dr. **Minarik**. Senator, you have, under the earned income tax credit, accounting procedures whereby an employer can count the prospective earned income credit against the payroll tax liability.

The **Chairman**. But you could do that with the VAT.

Dr. **Feldstein**. You could do that with this.

Dr. **Minarik**. You could do that with this. However, I think there are a couple of things. You would probably be in a situation in which the rebates exceeded the payroll tax liability in some cases. And in addition to that for employers, the accounting that is involved in that is really horrendous.

Dr. **Goode**. May I just add to that that while I agree that these technical problems are serious, I think there are more weighty objections to introducing a value-added tax as a major component of our revenue system.

Senator **Baucus**. Such as?

Dr. **Goode**. Such as its general lack of progressivity. It would finance a reduction in broadly progressive taxes to impose a tax which, at best, would be proportional over much of the income scale. And I think it would be wrong to suppose that it would have any particular beneficial effects on our international competitive position.

The **Chairman**. Senator Chafee.

Senator **Chafee**. I would like to change the subject and turn to the corporate deduction of 10 percent of the dividends paid. Now, in the material I saw, it said that costs about $25 billion—$24.8 billion.

Dr. **Feldstein**. That seems unlikely unless it is over a number of years.

The **Chairman**. That is for the full deduction, isn't it?

Dr. **Minarik**. That is for 5 years.

Senator CHAFEE. It seems like a lot to me.

The CHAIRMAN. Or else it is over 5 years at the 10 percent. I am not sure which.

Dr. MINARIK. It is over the 5 years.

Senator CHAFEE. Is that over the 5 years?

Dr. MINARIK. Yes, sir.

Senator CHAFEE. You are right. In any event, I am going to ask Dr. Feldstein and each of you what you think about this deductions. Is it a significant factor—an increase in capital formation? What do you think the results will be? Just 10 percent. Is it going to do any good?

Dr. FELDSTEIN. Frankly, I haven't focused on it as much as I probably should. I think it is a plus. The question is whether it is a plus that is worth the cost in comparison to other ways of helping capital formation. It is a plus that helps to right the balance between debt finance and equity finance. And that is really one of the serious problems of our corporate tax system—that we allow deductions for debt and not for dividends paid.

I think that at some point Congress should be looking at a much more substantial reform of the corporate income tax, if we are going to have one, which goes beyond the kinds of things that are being proposed here and that deals explicitly with this issue of debt versus equity finance. We make equity very expensive and debt very cheap under current tax rules. This is a small step in the right direction. From that point of view, it is a good thing.

Senator CHAFEE. Dr. Ture.

Dr. TURE. It is a step in the right direction, and I think in that respect it is not just good—it is very important. We should not think of this as eliminating—the so-called double taxation of dividends—as the be-all and end-all of getting rid of the bias against saving and capital formation to which the corporate income tax contributes, but it does alleviate it. Think how bad a signal it would be if the President had left that out of his proposal entirely. I think it is very important in terms of setting a precedent for future positive efforts to eliminate the tax on corporations.

Senator CHAFEE. Dr. Minarik.

Dr. MINARIK. Senator, that is the kind of a provision that economists love and very few other people tend to think it is worth a lot of money. In the short run, I think one thing we have to recognize is that there is a tendency of that dividend deduction to actually reduce capital formation, if it induces corporations to pay more dividends. And if the shareholders don't save all of those additional dividends, it may turn around and consume part of that. Then, that capital formation in the short run goes down—it doesn't go up. The nice thing about it is that we do under the current law have a bias against equity finance and, of course, debt finance, and that is what this provision is intended to deal with. The problem with it politically is that, to the extent the corporate managers sense that people—their shareholders—are going to want more dividends, they don't like it because they would rather retain the earnings and use them themselves. To the extent that the shareholders don't believe that they are getting any of the benefit from the deduction because the corporation actually gets the deduction, the shareholders presumably don't go for it either. And I think it is probably——

Senator **Chafee**. You are saying they don't like it because they will get more income and have to pay some tax on it?

Dr. **Minarik**. No, they don't believe they get the deduction. They may have little confidence that they are, in fact, going to be able to pull more dividends out of the corporation. So, the benefit to the shareholders seems hypothetical; if the corporation pays more dividends, then he will be better off. But he might not, and the shareholder might think he probably won't. From the point of view of the corporate manager, he is going to be presumably beat on the head by his shareholders to pay more dividends, and he doesn't like that. So, the problem with it, I think, is that the two parties in the process don't have any inherent reason to jump for joy over it.

Senator **Chafee**. Dr. Goode.

Dr. **Goode**. I think, Senator, that whatever you believe about the merits of reducing the so-called double taxation of distributed profits, it is not worthwhile for a 10 percent deduction to introduce this provision and give up $25 billion of revenue over 5 years, if the Treasury estimates are right. There are a number of technical issues involved in the proposal which the President's plan tries to address, but I question whether it is worthwhile trying to renegotiate our tax treaties in order to make sure that nonresident shareholders don't get the benefit of the deduction, or if they do, then we get some quid pro quo. There is the issue that any benefits that are accorded here by this method would accrue to tax-exempt shareholders. I don't find that so bad, but most countries that have tried to do something about this problem have felt they didn't want to give a benefit to either nonresidents or tax-exempt stockholders.

The **Chairman**. Senator Bradley.

Senator **Bradley**. Thank you very much, Mr. Chairman.

Senator **Chafee**. Mr. Chairman, could I just ask them one question? I didn't quite understand the benefit to nonresident shareholders. The problems that arise there would arise if you paid a regular dividend anyway, wouldn't they?

Dr. **Goode**. The problem is this. If you want to relieve the additional tax on distributed corporate profits, you can do it in either of two ways. You can do it by allowing the corporation to deduct the dividends paid—as this proposal says—up to 10 percent, and then that deduction applies regardless of who the shareholder is who gets the dividend. However, if you use the other approach, which the European countries have used—the so-called imputation system—you give the benefit direct to the shareholders, and you don't give benefits to the nonresident shareholders unless you are pressured to do so by some ad hoc negotiation between countries. And also, tax-exempt foundations and so on would not get the benefit normally under the imputation system. These are equivalent, aside from these technical questions, ways of reducing taxes on distributed profits, but the technical questions become quite important in connection with them.

Senator **Chafee**. Thank you.

The **Chairman**. Senator Bradley.

Senator **Bradley**. Thank you very much, Mr. Chairman. As you can tell from our discussion this morning, people tend to focus on one aspect of the President's bill and ask you: What do you think of this? And I think the point is that, if I read the mood of the committee or the mood of Congress, there is quite a possibility that there will be a totally different bill. It won't simply be the President's bill with one or another provision changed and therefore, I think from the standpoint of this committee, it would be helpful if you could, as economists, give us some general guidelines. And I would like to ask you whether you think a tax reform proposal should or should not do the following: Do you agree that any tax reform proposal should not increase the deficit? Yes or no? Dr. Feldstein.

Dr. **Feldstein**. Yes, with high probability.

Senator **Bradley**. Dr. Ture.

Dr. **Ture**. I would prefer that it did not increase the deficit.

Senator **Bradley**. Did not increase the deficit?

Dr. **Ture**. Yes.

Dr. **Minarik**. It definitely should not increase the deficit.

Dr. **Goode**. Very important not to increase the deficit.

Senator **Bradley**. OK. Do you agree that any tax reform proposal should not increase the relative tax burden on middle- and low-income people?

Dr. **Feldstein**. I think it should be distributionally neutral.

Senator **Bradley**. The answer then is yes.

Dr. **Feldstein**. Yes.

Senator **Bradley**. OK.

Dr. **Ture**. I would prefer to go about it in a little different way, Senator. I think that we haven't addressed——

Senator **Bradley**. You can pass on this if you want to. If you can't answer yes or no, you pass.

Dr. **Ture**. I think it is important for this committee and your companion committe in the House to address explicitly the question of an optimum distribution of tax liabilities and determine what you want to do with respect to that——

Senator **Bradley**. But what is your opinion? That was my question. Just take a pass. That is all right. Dr. Minarik.

Dr. **Minarik**. In answer to the question, yes.

Dr. **Goode**. It should not increase the relative tax on lower income families. Certainly.

Senator **Bradley**. OK. Middle income as well, Dr. Goode?

Dr. **Goode**. I will have to hear how you will avoid that. I am not sure that you can avoid it.

Senator **Bradley**. OK. Do you believe that any tax reform proposal should have the lowest possible tax rates for the greatest number of Americans? Dr. Feldstein.

Dr. **Feldstein**. There are ways that you could lower tax rates that would be a mistake, but understanding you are not thinking about those terrible thoughts—yes.

Dr. **Ture**. Lowest possible marginal tax rates—yes—provided the price you pay for them is not too high.

Dr. **Minarik**. Yes to the question.

Dr. **Goode**. I think we can over emphasize nominal tax rates.

Senator **Bradley**. You are for high tax rates?

Dr. **Goode**. Not for high rates, but I think there is too much emphasis on cutting tax rates per se as an objective, Senator.

Senator BRADLEY. OK. Fourth question. Do you believe that any tax reform proposal should be neutral in the allocation of capital—as neutral as possible? So, you shouldn't prefer certain assets over other assets?

Dr. FELDSTEIN. Again, I repeat what I said when we discussed this a few minutes ago. If you take as given that we are not going to eliminate the deduction for mortgage interest, then with respect to the other assets—no. If you can put mortgage interest on the same footing as everything else—yes.

Dr. TURE. I think that should be your paramount goal.

Senator BRADLEY. The paramount goal?

Dr. MINARIK. Yes.

Dr. GOODE. I think we should move in that direction, but I am not convinced that we need to go all the way.

Senator BRADLEY. OK. Thank you. One quick question. Take four facets: first, interest rates, monetary policy; second, value of the dollar; third, wages; fourth, ACRS, expanded capacity. What percent of the job of reducing inflation do you think each one of those things is responsible for? Inflation has dropped dramatically. What percent is due to interest rates? What percent is due to the value of the dollar? What percent is due to wage restraint? What percent is due to ACRS? Dr. Feldstein.

Dr. FELDSTEIN. I think the relevant thing is that I would give least weight to ACRS, and I think it is hard to separate the dollar and interest rates. I would say monetary policy has been the principal force, and it has worked through interest rates, through the dollar, and ultimately through wages.

Senator BRADLEY. OK. Dr. Ture?

Dr. TURE. Deceleration in the trend rate of increase and the monetary base I think is the principal factor responsible for the decline of inflation.

Senator BRADLEY. OK. Dr. Minarik.

Dr. MINARIK. I think Dr. Feldstein put it very well.

Dr. GOODE. I agree with Martin Feldstein.

Senator BRADLEY. OK. Just to follow up on this, Dr. Feldstein, you said of the four, clearly ACRS is the least responsible for the reduction of inflation. Would you care to give a ballpark percent—1 percent, 2 percent?

Dr. FELDSTEIN. No, that is not what ACRS was aimed at doing. Its job is to encourage investment which produces higher real incomes, not to try to be a substitute for monetary policy.

Senator BRADLEY. Thank you.

The CHAIRMAN. Senator Symms.

Senator SYMMS. To continue, Mr. Chairman, where I left off last time. The last thing that Dr. Feldstein said was that ultimately the value, or the price value, of a mine will be down because the tax benefits are against the value of the mine. Also, it appears in this bill that resource producing corporations are taxed more, timber companies, individuals that are in the mining business, agriculture, and so forth—because they will lose current tax benefits. Finally, property values in the 10 counties in Idaho that I mentioned that do have high percentages of second homes may drop. Does this mean that this bill is going to trigger a negative impact on values of real estate and resources production? Just yes or no in your opinion?

Dr. **Feldstein**. Especially the kind of resources you are talking about, yes.

Senator **Symms**. Dr. Ture.

Dr. **Ture**. May I offer a correction or an amendment of your premise? I wouldn't treat many of these necessarily as tax benefits. I think the rule I suggested before I would urge again. Does the present value of the various deductions for mineral resources or timber resources and so forth, that are allowed under present law, equal or exceed the present value of the costs you incur to produce those things? Only if the answer is yes do you have a tax benefit or a tax preference. Some work that was done in the Treasury some time ago suggests the contrary.

Senator **Symms**. Does this mean the value of the property in Idaho is going to be put in a deflationary spiral?

Dr. **Ture**. No. If you exact a larger tax draw out of the returns on those properties, they are going to be worth less.

Senator **Symms**. Worth less. Dr. Minarik.

Dr. **Minarik**. I think that is correct.

Senator **Symms**. Dr. Goode, do you think that is correct?

Dr. **Goode**. I think that is correct.

Senator **Bradley**. Would the Senator yield on just one point?

Senator **Symms**. Certainly.

Senator **Bradley**. On your recreation homes, the——

Senator **Symms**. Second homes.

Senator **Bradley**. Second homes. Do you have a $5,000 mortgage? You can have a $5,000 mortgage on your second home.

Senator **Symms**. $5,000 worth of interest?

Senator **Bradley**. Yes; you can deduct $5,000 worth of interest.

Senator **Symms**. I agree that—in many cases that might carry the mortgage. It might not, but if the prices all go down, then maybe it will carry the mortgage. [Laughter.]

Senator **Symms**. I will come back to this because it really troubles me. So, the next question I want to ask is: I have had an economist tell me that because of the six month delay when current tax deductions are lost on January 1, 1986 and lower the tax rates don't go into effect until July 1, 1986, that it may trigger economic behavior that will almost assure us a recession in the fall of 1986, or in the year of 1986. Do you agree with that precept, Dr. Feldstein? Yes or no?

Dr. **Feldstein**. I am not quite sure what the underlying idea is.

Senator **Symms**. OK, the underlying idea is that you are going to try to delay your income until after the tax rates are lowered, and to make your purchases early in the year, and then stop ordering things. You will try to prebuy things this year so you won't be buying anything next year because you have lost investment tax credits, ACRS, and so forth.

Dr. **Feldstein**. I think the proposed January 1986 ITC date would likely contribute to a recession in 1986. I am very worried about the idea of starting it with January 1986.

Senator **Symms**. Do you agree with that?

Dr. **Minarik**. Senator, I think that notion could very easily be overblown. For a taxpayer whose taxable year is the calendar year, it really doesn't matter whether you do your buying or your selling at any given time during the year.

Dr. **FELDSTEIN**. The ITC would matter. I think that is what the issue is.

Senator **SYMMS**. If the Treasury is doing this because of their static numbers, why wouldn't it be a good idea to move the date to March 1 or something and have them all go in effect the same day? Would that make more sense?

Dr. **FELDSTEIN**. I think 1986 is the wrong year for eliminating the ITC. I think the problem is that 1986 is a year when the economy will be soft, and I would postpone it until 1987, if at all.

Senator **SYMMS**. My time is about up, and I want to ask one more question. If our goal is to follow the President's tax proposal, why wouldn't it make more economic sense to pass the law that says we are going to reduce the tax rate by, say, approximately 2 to 3 percent a year for 10 years and, if you are still short of money, then you lump all of the deductions together—as Senator Chafee has suggested. Then you will be much closer to tax reform in the 10 years and give some stability in the economy and in the Tax Code? Just yes or no—would that be a better way to go? Economically, not politically.

Dr. **FELDSTEIN**. I like the idea of phasing down tax rates.

Senator **SYMMS**. Dr. Ture, do you agree?

Dr. **TURE**. Yes.

Dr. **MINARIK**. I would disagree, Senator. I think when you stretch these things out over a long period of time, you have problems with credibility, and you have problems of behavior that can be even worse.

Senator **SYMMS**. Dr. Goode.

Dr. **GOODE**. I agree with Joe Minarik. I think that is such a long stretch that it would be very difficult.

The **CHAIRMAN**. Senator Grassley.

Senator **GRASSLEY**. I am interested in impact upon small business, or I suppose I ought to say small corporations. And my understanding from Treasury I is that small corporations are very much opposed to it, thought it was very punitive and harmful. So, my question is: Have those concerns been addressed adequately from your point of view in the proposal we now have before us? No. 2, whether or not there is a special problem for corporations between $75,000 income and $140,000. It is my understanding that corporations below that $75,000—at least as far as tax paid—have been helped somewhat by the proposal. And then the third question would be directed just to Dr. Feldstein and Dr. Ture. In regard to your opposition to the proposal, but as you would compare its impact just upon small business versus larger corporations. From your point of view, even though you are opposed to it, does it more adequately address the problems of small business than it might in regard to larger corporations?

Dr. **FELDSTEIN**. The lower rates in Treasury II certainly are more helpful to small businesses up to $75,000 than they were in Treasury I. But the problems of reduced value of depreciation and the loss of the ITC still remains an issue. Indeed, the novelty in Treasury II is the recapture provision, and that could do substantial damage. I mean, you could certainly imagine a situation in which aiding back in some of this past depreciation could push a small business into being a larger business. I don't know what the proposal is with respect to small businesses, but if it is to apply that windfall recapture, so-called, to small businesses as well as to large businesses, that wouldn't make any sense at all because they are in very different rate situations.

Dr. TURE. Most small businesses will not be exposed directly to the recapture provision. Most of the small business organizations that I have had any contact with certainly think that the current proposal is an improvement—a substantial improvement—over Treasury's proposal last November. And I think they are enthusiastic supporters of it. It doesn't mean they don't anticipate any problems. Mostly, they do what everyone of us does, which is look at our own immediate tax situation, rather than look at what the overall effect of the tax proposal fully implemented will be on the economy and their situation in the economy. Most of those small businesses, after all, don't sell just to themselves. They sell to customers. A lot of those customers are big businesses. And sooner or later, they will start thinking about that.

Dr. MINARIK. Senator Grassley, you correctly said that this was a provision relative to small corporations and not small businesses, and of course, we have to keep in mind there are very few small businesses that are, in fact, corporations. To the extent that you have a small corporation, and to the extent that there is some reason why that small corporation could not do very well under this proposal by electing to be categorized as a Subchapter S corporation and taking advantage of the sharp reduction of individual rates, which it seems to me is the route towards which we should try to steer small corporations, then I would certainly say that Treasury II took care of their major concern, which was going to a flat corporate rate, with the gradation that is now there. I don't think that the notch problem that you mentioned in the $75,000 to $100,000 range should really be a serious problem. I would just suggest that if there is anything to be done, it should be attempting to get those corporations to be in a position to use Subchapter S.

Dr. GOODE. Of course, I think that owners of small businesses are pleased to see the reduced rates for smaller amounts of income, but I think in principle it is very hard to justify this. I think that Treasury I was probably right in saying last November there ought to be the same rate on corporations of all sizes. There are a lot of problems involved in splitting up businesses, as you know, and also it seems to me that the typical incorporated small business ought to be encouraged, as Dr. Minarik says, to move toward the Subchapter S treatment.

The CHAIRMAN. Gentlemen, I have no more questions. It has been a most illuminating morning. Thank you very much for spending this much time with us.

[Whereupon, at 12:09 p.m., the hearing was adjourned.]

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